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What went wrong in the euro area? How to repair it?

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The EU is facing two interrelated challenges. One is the unfinished, urgent and daunting task of managing crises and coordinating adjustment within the euro area. The other one is to draw lessons from the crisis and reform its governance, in order to avoid such crises occuring again. The first one is probably the most vital in the eyes of the markets but somehow the debate on the second has been given priority with the creation of the Van Rompuy task force. I will therefore focus on it.

1. What went wrong?

Any serious discussion on reform must start from an analysis of what went wrong in the euro area. A simple answer is that the rules are good but that implementation has been weak.

There is considerable truth in this view: Greece in the last decade defied the most basic provisions of the European budgetary framework – and even a fundamental tenet of membership in the EU - namely trustworthiness; several member states, some of which find themselves in difficulty, have constantly flouted EU budgetary principles; the EU had the legal means to tell Spain and Ireland that the course they were on was endangering their own stability and the stability of the euro area, but did not use them; finally, beyond formal rules, the Eurogroup had been given the mission to exercise vigilance, and it did not.

It is therefore tempting to conclude that the problem the Van Rompuy Task Force should address is purely one of enforcement of the existing EMU provisions.

Enforcement is certainly an important part of the agenda. However it would be wrong to stop at this level of analysis and limit the discussion to the design of additional sanction procedures. In fact we have learned much more from recent events and the lessons learnt should serve as a starting point for discussion on governance reform.

Five lessons have been learned – starting with the most basic ones.

1. ***Top-down government by statistics does not work*** (especially, but unfortunately not only, when they are wrong). In any organisation, a budget is a set of rules and procedures whereby spending is accounted for and controlled. For a government, it has a very different purpose than national accounts whose role is to record economic activity. Yet for reasons of comparability the whole EU budget monitoring system is

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based on the accounts prepared by the statistical office. The relationship to the actual budgets for the various entities that compose general government is often loose and this has been creating problems from the very beginning. Furthermore the monitoring of budgetary situations within the framework of the SGP has gradually evolved in the direction of putting emphasis on the structural, or cyclically-adjusted, balance – a further statistical construct. This is economically sensible, but as measuring the output gap is fraught with considerable uncertainty this puts the whole EU budgetary surveillance on shaky foundations.[1]

2. ***Deterministic governance does not work in a stochastic world*.** Spain moved between 2007 and 2009 from a 2% of GDP budget surplus to an 11% deficit, and Ireland from a balanced budget to a 14% of GDP deficit, while in the same period its debt jumped from 25% to 64% of GDP. Only a minor part of these changes is accounted for by discretionary decisions. So what we have learned is that a country can move almost instantaneously from an apparently sound to an alarmingly weak situation. In other words a deterministic approach is of limited help in a stochastic environment where tail risks can deeply affect budgetary outcomes.

   This questions the very basis upon which budgetary surveillance was based, namely that the soundness of a country's budgetary situation can be assessed with current data and forecasts. In such a stochastic environment a "value at risk" (which we should perhaps call "policy at risk") approach is instead called for. Furthermore the speed of change makes existing sanctions inappropriate: a country can be fined because its deficit has moved from 2.5% to 3.5% of GDP but there would be no point in fining it when the deficit is already in double-digit territory.

3. ***Ownership of the rules is very uneven***. At the end of the day success of EMU governance depends on the ownership of the rules by member governments and countries. Ownership has remained very uneven since the start of the euro. To take only one example, from 1997 (when the country qualified) to 2007 the government balance in France fluctuated between a 1.5% of GDP deficit and a 4.1% deficit whereas the SGP's stated target is that it should have been 'close to balance or in surplus'. This is *prima facie* evidence that this country – among several others – has had no ownership of the target it was committed to.

4. ***Not all problems are fiscal***. The implicit assumption in the EMU framework that threats to stability essentially arise from a lack of budgetary discipline has proven wrong. While the Greek case perfectly exemplifies how budgetary indiscipline in a small country may jeopardise financial stability in the euro area as a whole, Spain and Ireland illustrate that budgetary discipline, at least in the way it was assessed, is not sufficient to avoid major threats to economic and financial stability. So the lessons to be drawn are both that fiscal risks need to be prevented more effectively and that

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

non-fiscal risks arising from credit booms, asset-price developments and a sustained appreciation of the real exchange rate need to be addressed. This was actually already pointed out by the Commission in 2008 (European Commission, 2008).

To be fair, the 'it's all fiscal' assumption is nowhere explicit in the treaty. On the contrary Art. 121 (ex-99) is entirely devoted to the coordination of economic policies beyond the mere enforcement of budgetary discipline. But from the very beginning this pillar of economic union has always been significantly softer than the fiscal one based on Art. 126. Not only are the legal provisions weaker, but over the first ten years of the euro they have not really been used. The Broad Economic Policy Guidelines that were supposed to be the backbone of coordination have been consistently ignored by national policymakers; and the possibility of issuing a recommendation was used only once – without effect.

5. ***A commitment to no-assistance is not credible.*** There was never a 'no-assistance principle' in the treaty, only (and rightly so) a 'no-coresponsibility' principle for public debts (Art. 125). Art. 143 which limits the benefits of macro-financial assistance to EU countries not belonging to the euro area was not intended to prohibit assistance to euro-area countries, it was only the result of the view that the members of the monetary union would not need balance-of-payments assistance anymore (Marzinotto, Pisani-Ferry and Sapir 2010). But, until Greece, there was the *belief* that a member country would be allowed to default rather than be provided with assistance.

   Ambiguity has now been removed but this does not clarify the endgame. In fact it has been replaced by another ambiguity: what if a member government benefiting from EU assistance remains unable to regain access to the market? Will it remain dependent on an assistance lifeline or on purchases of bonds by the ECB? As long as this ambiguity persists there will be room for speculation as regards the nature of the solution to insolvency cases.

   In other words EU assistance does not necessarily weaken discipline *ex ante* (it may even strengthen it as it gives undisputable legitimacy to surveillance by EU partners) but it requires a clarification of the rules of the game in case of insolvency.

2. Three choices for reforming governance

These lessons indicate that the problems run deeper than a mere enforcement issue. As the Van Rompuy Task Force discusses avenues for reform it should in fact go beyond and address some strategic choices for reform. On the basis of lessons learned, three choices are worth highlighting.

1. ***How many objectives*?** Besides price stability, which is assigned to the ECB, in its first ten years EMU has had budgetary discipline as its main objective. Another objective, the 'proper functioning of economic and monetary union', was mentioned in Art. 121

(ex-99) but it was ill-defined in the treaty and was not made operational through secondary legislation.

The Commission has (rightly) indicated that macroeconomic surveillance should be expanded 'beyond the budgetary dimension to address other macroeconomic imbalances' (European Commission, 2010). But this implies that there are now three objectives in EMU:

- Budgetary discipline
- Financial stability (which has emerged as paramount in the aftermath of the crisis) and
- The avoidance of macroeconomic imbalances.

This complicates the policy framework significantly, especially as these objectives are partially distinct and partially overlapping and are not defined with great precision. It is not clear whether EU governments have the required instruments to meet these three objectives simultaneously and, if so, which instrument should be assigned to what objective.

Conceptually, it could arguably be sufficient to adopt financial stability as the overriding objective as both fiscal crises and crises stemming from macroeconomic imbalances *ultimately* result in financial instability.

This is however only true in the long run and experience shows that budgetary or macroeconomic imbalances can go on for a very long time before they ultimately result in a financial crisis. Operationally, therefore, it is preferable to retain three distinct objectives. But this implies a reformulation of the policy framework so that assignments are clearly defined.

2. ***What relationship between crisis prevention and resolution?*** The Maastricht regime was incomplete because it was entirely based on crisis prevention and made no room for crisis management and resolution. When the crisis hit it was felt that to let a member country default was too risky an option and there was no choice but to invent on the spot a crisis management regime. The question however is now to redefine the relationship between *ex ante* surveillance and *ex post* crisis resolution.

   It is now hardly imaginable to return to the previous regime. If so, a full crisis resolution regime needs to be defined, whereby the principles and modalities of assistance, debt restructuring and possibly exit are set out in detail. If exit is (sensibly) ruled out because of its potential spillover effects, then this only strengthens the case for defining the debt resolution regime. As the EU is a community of law there is a strong case for establishing rules and modus operandi for a statutory European Debt Resolution Mechanism. Current reluctance to create expectations of an imminent default should not serve as an excuse for refusing to work out the whole set of principles upon which EMU reform needs to be based. Half measures now would only perpetuate the incomplete character of the system.

3. ***How much centralisation?*** The attempt at enforcing budgetary discipline from the top in the first ten years of EMU has not been without impact but it has not been a great success either. The question now is whether the EMU objectives, especially budgetary discipline, have a better probability of being achieved in a more decentralised system.

   It is perfectly possible to imagine an alternative scenario where budgetary discipline would result from a combination of institutional reforms at domestic level and market forces. As Germany has now adopted a new budget rule, and as markets benchmark the fiscal creditworthiness of each participating country against Germany, there is a new logic gaining momentum that could result in Germany becoming the anchor again and the other member states emulating its institutional reforms. Recent French announcements go in this direction.

   Indeed this is exactly what happened twenty years ago in the monetary field. The EMS had been created in 1979 as a perfectly symmetric system with the ECU as a collective anchor. By the late 1980s it was increasingly evident that it had turned into an asymmetric system with the German mark at the centre. The question now is whether the SGP – today's collective anchor – will in the same way be superseded by a national anchor.

   Whether governance reforms should encourage decentralisation through providing an umbrella framework for national rules and institutions and through in some way rewarding countries with better institutions is a strategic choice for the EU. There are strong economic and political-economy arguments in favour of such an approach, though this would admittedly be a break with the past and would raise a number of difficulties.

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Discussions on euro-area governance have been going on at least since the first negotiations on the creation of the euro. They have not been settled because of the ambiguities in the positions of the key participating countries, especially Germany and France, and the ambiguities in the compromises they had reached (Pisani-Ferry, 2005).

But something new has happened. As Keynes reportedly asked, "When the facts change, I change my mind. What do you do?" This crisis is indeed an opportunity for clarification. In order not to waste it, the Van Rompuy Task Force should resist the temptation to patch up divergences and should address the fundamental questions about the principles upon which EMU is based.

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