THE EURO-ZONE CRISIS AND REFORMING ECONOMIC GOVERNANCE

MARIA JOÃO RODRIGUES

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Any further information can be obtained through FEPS Secretary General Ernst Stetter at
ernst.stetter@feps-europe.eu

Introduction

The European Union is now confronted with the need to undertake broad and deep reforms in its economic governance. The “Greek crisis” led to the invention of new instruments to deal with sovereign debt but it has also unveiled more general and structural problems in the euro-zone. We can now understand that its long term sustainability will depend on several conditions to be met:

- Fiscal responsibility coupled with a last resort solidarity regarding sovereign debt
- A reformed financial system to ensure financial stability and promote growth
- A stronger coordination of economic policies combined with structural reforms to enhance growth potential
- The reduction of the internal divergences. In the long term it is difficult to ensure the nominal convergence between the euro-zone members without increasing their real convergence.

Several European instruments are missing to meet these conditions and the need of urgent reforms in economic governance is made clear by the current challenges:

- Ensuring the external credibility of the euro-zone, in financial and political terms
- Fostering the economic recovery while improving fiscal consolidation
- Launching a long-term strategy for a smarter, greener and inclusive growth with the means to ensure success.

These challenges are completely intertwined: the strength of the euro-zone depends not only on fiscal consolidation but also on ensuring a stronger recovery while reducing the internal divergences. This complex equation can only be solved by combining national and European instruments. In the current level of interdependence, the Member State’s efforts regarding fiscal consolidation, growth and structural reforms can only succeed if they are also supported by stronger coordination and stronger European instruments regarding fiscal consolidation, growth and structural reforms.

Moreover, all EU governments are now being confronted with a difficult dilemma: how can they begin to reduce their public deficits and debt whilst simultaneously fostering the economic recovery they badly need to counter rising unemployment? This “catch-22” situation certainly requires new developments of the available instruments of European economic governance, and it must be borne in mind that the level of interdependence among EU Member States is such that the time has come to coordinate, not simply to avoid negative spill-over effects, but also to take full advantage of the positive ones.

In this paper we have built, first of all, a more comprehensive and systematic theoretical framework to analyse the economic governance of the European Union. Secondly, bearing in mind this framework, we make a brief assessment of past and recent developments. Finally, we will address the missing governance mechanisms by presenting some proposals of reform.

1. A Framework for Developing Economic Governance

Effective economic governance should make use of both European and national instruments to ensure that four fundamental functions are carried out:

- fiscal consolidation
- financial stabilization
- managing external relations
- and promoting sustainable growth (by economic stabilization, allocation and redistribution of resources)

Table 1 in annex shows how these various functions can be carried out using various macro-economic policies, namely monetary, budgetary, tax and wage policies. More specifically, we identify the main instruments that are already used, those activated with the financial and economic crisis and, finally, those that do not yet exist but should be developed urgently (see capital letters in red)

2. A Limited Historical Experience

The economic governance of the euro-zone is still a "work in process", reflecting its short historical experience in this field. It began with the coordinated preparation of the conditions to create a monetary zone, followed by a coordinated exercise to control inflation and further consolidate public finances. The coordination of budgetary policies to promote sustainable growth, which is an implicit part of the economic leg of the Economic and Monetary Union, lagged behind since its creation. Some years later, it was identified as the fourth strategic priority of the Lisbon Strategy, when this was adopted in 2000 as a comprehensive development agenda for the European Union. Nevertheless, this coordination for growth was soon downplayed to give way to the priority goal of coordinating fiscal consolidation.

In the meantime, German domestic development problems arising from unification, as well as other national difficulties, led to a revision of Stability and Growth Pact in 2005. This allowed some room to differentiate consolidation trajectories and to respond to different structural reform and investment needs. Nevertheless, even this limited room of manoeuvre was questioned by pressures for uniform fiscal consolidation, with the argument that all Member States confronted increasing problems with the sustainability of social protection – which is certainly the case. Apparently, the idea did not consider that the best way to cope with such pressures is to increase the potential for growth and to foster investment and job creation. In this context, the monitoring of the quality of public finances was only about promoting efficiency, and their effectiveness to attaining these central strategic objectives was downplayed.

The result was that growth remained a secondary goal subordinated to the focus on fiscal consolidation, with the aim of reaching a near balance or surplus public budget. ECB action was

shaped by the same hierarchy of goals, guided by a Treaty-based mandate that establishes inflation control as a clear priority. Finally, the management of external relations remained incipient, given the basic problems posed by external representation in the Bretton Woods institutions or the G7/8.

3. Coping with the Financial and Economic Crisis

The financial and economic crisis subjected EU economic governance to tough tests, confronting the Union with the need to deploy new instruments or create them from scratch:

- First, regarding financial stabilization: we recall the higher liquidity and the set of unconventional measures provided by the European Central Bank, a regulatory package to reform the financial system in line with G-20 international commitments, and the creation of two supervisory bodies, the European Systemic Risk Board and the European System of Financial Supervisors;

- Second, regarding economic stabilization: the automatic stabilizers were deployed, together with additional fiscal stimulus packages to provide financial support to banks in order to avoid bankruptcies and restore credit, and to businesses in order to prevent massive job destruction:

- Third, regarding the allocation of resources: the threats to the Single Market posed by protectionist reactions by some Member States were addressed by a stronger monitoring and coordination of State aids to support banks and companies;

- Fourth, regarding redistribution: there was an added budgetary effort to permit higher expenditure on social policies, coupled with the front loading of Structural Funds

- Fifth, the emergence of G-20 at leaders' level generated pressures to reform the EU's external representation, not only within the G-groupings but also in the Bretton Woods institutions and the bilateral summits with the Union's international partners, while there were major uncertainties about the ratification and implementation of the Lisbon Treaty.

The crisis was managed as a result of this exceptional public intervention, but we cannot say that it has been overcome and even less prevented. In order to overcome this kind of crisis, it will be necessary to ensure sustainable growth in today's globalised conditions, and in a way that takes ageing and climate change into account. Preventing such crises, on the other hand, requires addressing its more fundamental roots, notably insufficient regulation of the financial system and corporate governance as well as major global economic imbalances.

Moreover, the crisis has also revealed specific Euro-zone problems: first, speculative attacks against non-euro-zone countries were addressed by strengthening the Community Facility for balance of payments, and through the first intervention of the IMF in the history of the European Union. Later, a

new form of speculation emerged, which affected the sovereign debt of euro-zone member States – Greece offering the most acute example of this – revealing another clear institutional failure in the institutional architecture of the euro-zone.

After a painful period of three months of political declarations and ad-hoc solutions, the euro-zone finally agreed on creating a Community instrument to support Member states in risk of a sovereign debt default as well as an instrument based on national guarantees (Special Purpose Vehicle).

4. Urgent Developments for the Euro-Zone Governance

Collective political vision and leadership will be necessary to develop the governance of the euro-zone. Some priority reforms can already be clearly identified (see Box below) and we will present with more detail those which are still not agreed or in implementation.

THE PRIORITY REFORMS FOR EURO-ZONE GOVERNANCE

a) Undertaking the planned **reforms of the financial system**

b) Building the **European financial supervision bodies**

c) Equipping the euro-zone with a permanent mechanism to prevent **sovereign debt default**

d) Improving the **surveillance regarding fiscal consolidation** with ex-ante coordination and a stronger focus on the long term sustainability of the public debt

e) Coordinating the redirection of **public expenditure to promote key investments**

f) Making **the best of the positive spill-over effects**, increasing European aggregated demand.

g) Coordinating the shift **of the tax burden to new sources**

h) **Developing a new European instrument to create better conditions for Member states to issue national debt for key investments**

i) **Monitoring and reducing the macro-economic imbalances in the euro-zone**

As regards financial stabilization, it is crucial to regain sovereignty over speculative pressures exerted by financial markets. This will require:

a) Undertaking the planned **reforms of the financial system**

b) Building the **European financial supervision bodies** and enforcing their decisions

c) Equipping the euro-zone with a permanent mechanism to prevent sovereign debt default, by coupling national fiscal responsibility with a last resort effective European solidarity. This mechanism should not only **protect the euro-zone from speculative attacks, but also reduce the level of public debt spreads.**

The most daunting challenge, however, will be ensuring fiscal consolidation whilst boosting recovery. Moreover, recovery cannot be seen as a return to the past, but rather as a transition toward a new low-carbon, knowledge-intensive and more inclusive growth model. Basically, the euro-zone faces two central choices:

- Either to prioritise fiscal consolidation and sacrifice recovery or to prioritise recovery while paving the way for consolidation. Investment and job creation are essential for a more effective strategy of fiscal consolidation as they reduce the costs of social protection and increase tax revenues. Higher rates of growth and concomitantly higher public revenue, together with returns generated by public investments, can help to reduce public debt. The cuts introduced in public spending should not damage this central process
- Either to impose a uniform pace for consolidation or leave some room of manoeuvre to foster real convergence, accommodating different investment needs, welfare system reforms, patterns of specialisation and their implications for the asymmetric shocks stemming from the financial and economic crisis.

Depending on which choices are made, the euro-zone can expect two different scenarios:

- If it chooses to move uniformly to attain fiscal consolidation quicker, it risks internal fragmentation, with many regions stagnating or trapped by recession
- In order to prevent such tensions, the urgent response should combine fiscal responsibility with stronger coordination of economic growth policies and with new European instruments to finance growth

In order to deal with this central dilemma over the next few years, fiscal policies should undergo some important changes:

d) improving the **surveillance regarding fiscal consolidation** with ex-ante coordination and a stronger focus on the long term sustainability of the public debt

e) coordinating the re-direction of **public expenditure to promote key investments** to foster a more low-carbon, knowledge-intensive and inclusive growth model and to prioritise jobs

creation, making a clear distinction between "good" and "bad" spending cuts. Member States that are more able to undertake this shift should have more time to reduce their public deficit and debt. The improvement of the quality of public finances should be rewarded.

f) to **make the best of positive spill-over effects**, increasing European aggregated demand. The starting point should be to estimate the aggregate effect of Member state public investments projected for the coming years.

g) coordinating the shift **of the tax burden to new sources**, notably pollution and financial transactions, so as to avoid overburdening labour costs, which would damage jobs creation and social fairness. If it is to work properly, this re-direction of tax policies also requires better European coordination.

h) **Developing a new European instrument to create better conditions for Member states to issue national debt**, in order to support new long term investments needed to promote the transition to a more low-carbon, knowledge-intensive and inclusive growth model. The issuance of **euro-denominated bonds** is already happening successfully within the framework of the Community Facility to support non-euro-zone EU Member States with balance of payments problems.

i) **Monitoring and reducing the macro-economic imbalances in the euro-zone.** Some macroeconomic imbalances were magnified by the crisis and are now more visible in the current accounts and the balance sheets of households and companies. Their underlying causes might be explained by unsustainable public spending, wage developments or by lack of productivity improvements. Nevertheless, in the present conditions, they are also explained by lack of demand for investment and consumption at European level, inequalities in income distribution, increasing unemployment and poverty, deeper regional inequalities and lack of effective instruments to finance public budgets. Therefore, multilateral surveillance should follow-up these different dimensions in order to identify the appropriate and specific solutions. Beyond the national specific solutions, there are general principles which should be implemented. Macroeconomic imbalances can be reduced by better conditions for recovery in all Member States, which require more European coordination.

These developments are possible within the current legal framework:

- Operationally, these reforms require a very precise updating of broad economic policy guidelines, followed by multilateral surveillance "to ensure closer co-ordination of economic policies and sustained convergence of the economic performances of the Member States" (TFEU, Art 121.2,3 and 4).

- Hence, surveillance and recommendations should be based not only on public deficit, public debt and economic growth indicators, but also on others measuring trade and external balances, the quality of public finances, investment, employment and the goal of making the transition towards a more low-carbon, knowledge-intensive and inclusive economy.
- The revised Stability and Growth Pact (see European Council conclusions in March 2005 Paragraphs 2.1., 3.1., 3.3. and 3.7) provide room of manoeuvre to increase the time available to reduce excessive deficits, according to the effort to re-direct public finances and to this more general assessment of each national case.
- A final test of consistency should involve cross-checking stability and growth programmes with national reform programmes under the EU 2020 Strategy.
- Finally, the new Chapter 3a of the TFEU on the euro-zone strengthens the scope for coordination and monitoring, including external representation.

Indeed, this is the other major EU economic governance development that is urgent:

j) It is necessary to ensure the **more consistent external representation of the euro-zone** in the Bretton Woods institutions and the G-20, to promote better external conditions for the implementation of these internal priorities. This is especially important in the areas of financial regulation, recovery coordination, monitoring protectionism and improving environmental and social standards.

The European Union needs to reform its economic governance if it wants to consolidate the euro-zone, deliver a real recovery and implement the EU2020 Strategy. Otherwise, it may face a lost decade, marked by a fragile recovery or stagnation, an EU 2020 Strategy that is less effective than the Lisbon Strategy, deeper regional and social inequalities and a weaker euro-zone.

A final question for you to reflect on: do you really believe that the implementation of the EU2020 Strategy will be more successful than that of the Lisbon Strategy if the instruments are basically the same and when the starting conditions are so much worse?

The development of EU economic governance must certainly take political centre stage.

TABLE 1

DEVELOPING EUROPEAN ECONOMIC GOVERNANCE

Instruments by Macroeconomic Function and by Policies

POLICIES **FUNCTIONS**	MONETARY POLICY	EXCHANGE RATE POLICY	BUDGETARY POLICY COMMUNATARY LEVEL	BUDGET POLICY NATIONAL LEVEL	TAX POLICY	WAGE POLICY
FISCAL CONSOLIDATION	ECB + national central banks		Financial Regulation of the Community Budget	Stability and Growth Pact (public deficit and debt) **FISCAL SPACE FOR INVESTMENT**	Taxation levels	
FINANCIAL STABILIZATION	*European Supervision Bodies* *Financial Regulation*		*European mechanism for financial stabilization*	*Public support to financial institutions*		
PROMOTING SUSTAINABLE GROWTH **Economic stabilization**	ECB *Balance of Payments Facility*	*Balance of Payments Facility*	*Frontloading Structural Funds*	Automatic stabilizers *Time and structure of withdrawing fiscal stimulus* **REDUCING THE MACROECONOMIC IMBALANCES**	Taxation levels	Wage flexibility
PROMOTING SUSTAINABLE GROWTH **Allocation**			Community Budget structure European Investment Bank **EUROBONDS**	Budget structure Quality of public finances **REWARDS OF REDIRECTION OF PUBLIC SPENDING TO INVESTMENT** **STRUCTURAL REFORMS** **EU20220**	Tax incentives	Wage/productivity

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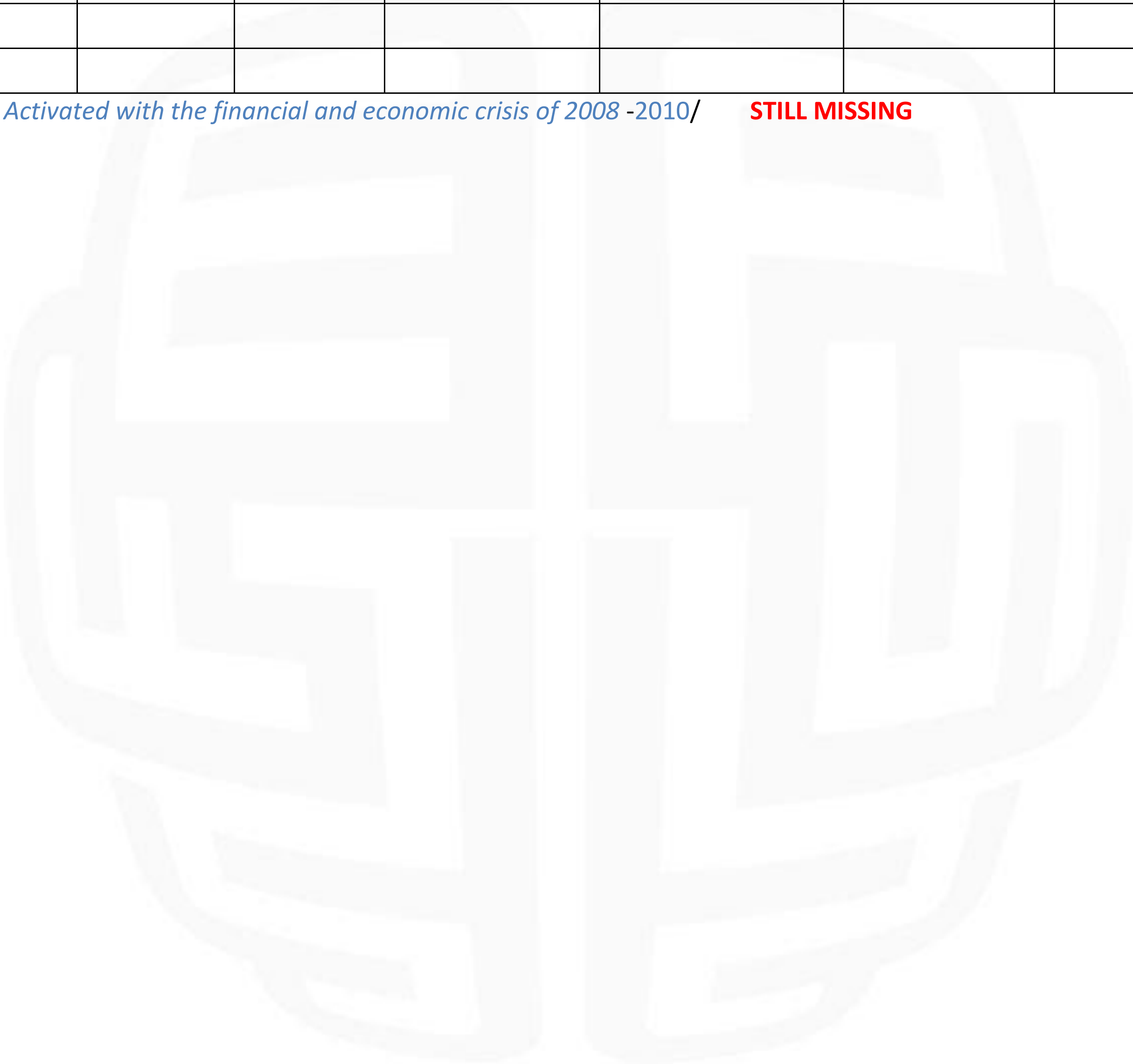
PROMOTING SUSTAINABLE GROWTH Redistribution			Structural Funds *frontloading*	Budget structure State aids Social benefits	**COORDINATION OF TAX SHIFT TO NEW SOURCES**	Wage structure
EXTERNAL REPRESENTATION	ECB			**EURO-ZONE REPRESENTATION IN BWs, G-8, G-20**		

Activated with the financial and economic crisis of 2008 -2010/ **STILL MISSING**



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