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Rebalancing the governance of the euro area

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Abstract

Alongside the setting-up of a crisis management regime and the creation of a banking union, the strengthening of economic governance has been a major pillar of the European Union's response to the eurozone crisis. Between 2010 and 2014, the Economic and Monetary Union (EMU) was the subject of a series of reforms, more than ever before in such a short time span. Yet, two years after this major legislative effort, few policy-makers would dare to claim 'mission accomplished'. This paper outlines and discusses alternative possible directions for the reform of euro area's economic governance. To this end, the reforms introduced in recent years, as well as the main shortcomings of the resulting policy system, are briefly reviewed. The paper then proceeds with a presentation and analysis of alternative templates for governance reform and concludes with proposals for a practical agenda.

Keywords: crisis management, economic governance, European Union, Economic and Monetary Union, reform

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Résumé

Depuis 2010, la gouvernance de la zone euro a fait l'objet de plusieurs réformes : institution de la Troïka FMI-Commission-BCE, création du Mécanisme européen de stabilité (MES), adoption des paquets législatifs dits Six-Pack et Two-Pack, nouveau Traité sur la stabilité, la coordination et la gouvernance (TSCG), mise en place enfin d'une union bancaire. Jamais, dans l'histoire de l'UE, autant de réformes n'avaient été introduites en si peu de temps. Peu de responsables jugent pourtant qu'il suffit désormais de cueillir les fruits de cet effort. En octobre 2014, les chefs d'État et de gouvernement de la zone euro sont convenus de la nécessité de développer des « mécanismes concrets » pour renforcer « la coordination des politiques économiques, la convergence et la solidarité ». Un rapport des quatre présidents (Commission, Conseil, BCE et Eurogroupe) doit présenter des propositions. L'objet de cet article est de recenser ce qui a été accompli, d'évaluer les déficiences qui subsistent dans le système de gouvernance économique, de discuter les modèles alternatifs d'organisation de la politique économique en zone euro, et enfin de formuler des propositions concrètes pour l'avenir.

La réforme de la gouvernance de la zone euro s'est déployée sur trois fronts : le renforcement de la surveillance préventive dans les domaines budgétaire, économique et macro-financier ; la création d'un régime de gestion des crises souveraines ; et l'intégration de la supervision des banques et de la résolution de leurs crises. Si l'Union a été audacieuse sur les deux derniers points, elle l'a été sensiblement moins en matière de prévention des crises : la réforme de la surveillance a essentiellement consisté en un renforcement du Pacte de stabilité et de croissance (PSC), complétée par la création de mécanismes de surveillance macro-économique.

Le système résultant de ces initiatives souffre de plusieurs défauts :

- une complexité excessive, qui contribue à faire obstacle à son appropriation par les décideurs nationaux. Le volume de la législation secondaire relative à la gouvernance économique de la zone euro a triplé entre 2008 et 2014 ;
- le maintien d'un biais pro-cyclique dans l'orientation de la politique budgétaire. Ce biais, ancien, n'a été contredit qu'en 2009. Dès 2010, l'orientation budgétaire d'ensemble de la zone euro est redevenue pro-cyclique. Pour l'avenir, on peut craindre que la mémoire des crises souveraines conduise à une insuffisance de stabilisation en période de ralentissement ;
- un écart d'effectivité entre la surveillance budgétaire et la surveillance macro-économique, que la création de la procédure pour déséquilibres macro-économiques excessifs n'a pas réussi à combler. Cette procédure souffre de son asymétrie (les excédents extérieurs sont jugés plus graves que les déficits) et du caractère indirect de la relation entre instruments et objectifs de politique économique ;

– la persistance du syndrome OHIO (*Own House In Order*) au gré duquel l'intérêt collectif de la zone euro est servi au mieux quand chaque État mène, pour ce qui le concerne, une politique orientée vers la stabilité. L'intérêt collectif de la zone euro demeure mal pris en compte et ceci a des inconvénients notables en matière de gestion de la demande (absence de capacité budgétaire commune), de coordination des réformes et de relations avec le reste du monde ;

– des institutions faibles. Seule la BCE est sortie renforcée de la crise, tandis que la Commission a été affaiblie, notamment par la création du MES, et que l'Eurogroupe souffre de n'avoir pas bien rempli son rôle de prévention et de s'être fait déposséder d'une partie de ses responsabilités par les chefs d'État et de gouvernement.

Les discussions sur l'avenir de la zone euro tendent à se centrer sur le point de savoir s'il convient de réviser les traités. La question sera importante pour l'avenir, mais dans l'immédiat l'attention devrait davantage porter sur la direction dans laquelle la zone euro doit évoluer. Trois modèles de son avenir coexistent en effet :

– un modèle décentralisé correspondant à une union monétaire minimale, sans solidarité budgétaire ou financière et sans dispositifs élaborés de surveillance des politiques nationales, mais dotée de mécanismes de résolution des crises souveraines et de limitation de leurs conséquences sur le système financier. Peu réaliste tant politiquement que financièrement (parce qu'il suppose un beaucoup plus faible endettement des États), ce modèle présente néanmoins l'intérêt d'être logiquement cohérent et offre à ce titre un point de repère utile ;

– un modèle fédéral au gré duquel la zone euro se doterait graduellement d'un budget spécifique et d'un système de gouvernance organisé autour de la Commission, avec pour pendant un contrôle par le parlement européen. Plutôt que sur des mécanismes de coordination, la zone euro évoluerait vers une délégation de certaines fonctions économiques au niveau central, en matière de stabilisation notamment. Ce modèle souffre d'avoir perdu de sa crédibilité dans le contexte politique actuel de montée de l'euroscepticisme, mais aussi de ne pas offrir de réponse au problème que la qualité du fonctionnement d'une zone monétaire dépend moins du degré de centralisation des décisions que de la cohérence entre politiques nationales et objectifs communs. En d'autres termes, la fédéralisation n'éliminerait pas le besoin de coordination ;

– un modèle hybride, qui prenne appui sur l'existant pour combiner plus de centralisation dans certains domaines et, dans d'autres, à la fois plus de décentralisation et plus de prises en compte dans les décisions nationales des contraintes qu'implique la participation à une monnaie commune. C'est ce modèle qu'il s'agit de construire.

En matière de finances publiques, il est souhaitable de simplifier le système de surveillance en favorisant la décentralisation de la responsabilité budgétaire. Cette direction a déjà été prise avec la création, requise par le TSCG, de comités budgétaires indépendants (en France, le Haut Conseil des finances publiques). L'évolution doit être poursuivie : ces conseils devraient voir leur responsabilité élargie aux prévisions de recette, à l'évaluation du coût des mesures législatives et à l'analyse de la soutenabilité des finances publiques ; ils devraient s'organiser en réseau, autour d'un conseil similaire pour l'ensemble de la zone euro ; et l'Union devrait inciter les États à accroître leur rôle en donnant, dans le cadre du Pacte de stabilité, plus de marges de manœuvre aux pays dotés d'institutions crédibles et effectives.

Des conseils de compétitivité devraient être mis en place sur le même modèle pour évaluer, dans chaque pays, l'évolution de la compétitivité relative et les déséquilibres extérieurs. Ces conseils, qui devraient également fonctionner en réseau, pourraient utilement formuler des recommandations à l'échelle nationale sur la formation des salaires et des prix, ainsi que sur la compétitivité hors-coût.

En matière de solidarité, il est souhaitable de compléter le dispositif actuel qui est marqué par une très forte discontinuité entre l'état d'autonomie et l'état de sujétion des pays sous programme Troïka. Il faudrait aller vers un système plus graduel qui permette à un pays de bénéficier plus précocement du soutien de ses partenaires, soit sous la forme de prêts à conditionnalité allégée, soit sous la forme d'un accès à une tranche d'emprunt bénéficiant d'une garantie mutuelle. Naturellement, une telle facilité devrait avoir de strictes contreparties en matière de discipline budgétaire, notamment un droit de veto des partenaires sur les budgets des pays qui y auraient recours.

Une capacité budgétaire commune doit surtout être envisagée comme un instrument de réponse à des situations d'urgence macro-économique ou financière, et non comme un instrument de stabilisation. Il importe notamment de ne pas faire reposer la réponse à des risques économiques sur la seule politique monétaire. On peut concevoir que cette capacité budgétaire repose soit sur la coordination (avec, dans ce cas, un mécanisme de décision), soit sur une capacité commune d'emprunt.

Enfin la réforme de la zone euro devra également concerner les institutions. Le système actuel, qui voit coexister une Commission disposant de moyens humains et un Eurogroupe qui en est dépourvu, n'est pas un état stable. Soit on évolue vers une présidence fixe de l'Eurogroupe, qui appellera inévitablement le développement d'une structure administrative de soutien et donc une gouvernance à deux têtes ; soit on adopte le modèle en vigueur pour les affaires étrangères et l'on confie au Commissaire ECFIN la présidence de l'Eurogroupe, ce qui impose évidemment qu'il ne soit plus chargé de l'instruction des dossiers de surveillance des États. Selon le modèle qui sera choisi, différentes procédures de contrôle démocratique devront être mises en place.

Rebalancing the governance of the euro area

Jean Pisani-Ferry[1]

Introduction

Alongside the setting-up of a crisis management regime and the creation of a banking union, the strengthening of economic governance has been a major pillar of the European crisis response. Between 2010 and 2014, the Economic and Monetary Union (EMU) went through a series of reforms: the introduction of cooperation between the International Monetary Fund (IMF), the European Commission, and the European Central Bank (ECB) in the monitoring of financial assistance (the Troika); the creation of the European Stability Mechanism (ESM), the euro area's financial assistance arm but also a genuinely new institution; the adoption of the Six-Pack and Two-Pack legislative packages that aim at strengthening and broadening the surveillance apparatus; the further agreement of a new Treaty on Stability, Coordination and Governance (TSCG), whose main provisions strengthen the participating countries' commitment to fiscal discipline; and last but not least, the initiation of a banking union among euro area countries. Never before in the history of the European Union (EU) had so many reforms been introduced within such a short time span.

Two years after this major legislative effort was completed, however, few policymakers would dare to claim 'mission accomplished'. In his first speech to the European Parliament Jean-Claude Juncker, then still candidate to the presidency of the Commission, pledged to 'continue with the reform' of the EMU, taking inspiration from the 2012 report of the four presidents (van Rompuy et al. 2012), and from the Commission's 2012 'Blueprint for a deep and genuine EMU' report (European Commission 2012). Mario Draghi, the president of the ECB, has also emphasised the incompleteness of the EMU. In a speech in July 2014, he underlined the case for 'some form of common governance over structural reforms… because the outcome of structural reforms is not merely in a country's own interest [but] in the interest of the Union as a whole' (Draghi 2014a). And in his Jackson Hole speech of 22 August 2014 (Draghi 2014b), he called for 'a discussion on the overall fiscal stance of the euro area', thereby breaking with the tradition of considering fiscal matters on a country-by-country basis only.

(1) France Stratégie, Paris, and Hertie School of Governance, Berlin. I am grateful to Paul Berenberg-Gossler for effective research assistance as well as to Vincent Aussilloux and Arthur Sode for comments on an earlier version. This paper was prepared for the Hertie School Governance Report (forthcoming Oxford University Press, 2015).

Academics and observers have also contributed to the discussion, as various groups and individuals put forward a series of blueprints for a genuine EMU (see Enderlein et al. 2012; Allard et al. 2013; Glienicker Gruppe 2013; Eiffel Group 2014; Piketty and Rosanvallon 2014; Vallée 2014; Pickford, Steinberg, and Otero-Iglesias 2014; Enderlein and Fritz-Vannahme 2014) that combine in various proportions ingredients for further integration and discuss their institutional implications. Different protagonists have different perspectives on what should be added to the existing framework. Fiscal union, a common budget, a common fiscal backstop to bank crisis resolution, a sovereign debt resolution procedure, the coordination of structural reforms, and labour mobility are among the most frequently mentioned additions to the existing set-up. As the assignment of new and extensive powers to the euro area level is hardly imaginable without strengthened accountability procedures, the authors of these proposals also discuss the reforms of the euro area governance system that would need to accompany it.

At the other end of the spectrum, other observers contend instead that Europe has already gone too far and that adding further competences to those already transferred to the euro area level would be an illusory solution (Mody 2013). They rather recommend dismantling the existing web of surveillance procedures and simplifying the existing architecture radically, putting emphasis on decentralisation and the individual responsibility of the member states—up until an eventual sovereign bankruptcy.

There are several reasons for this revival of discussions on the future of the EMU. First, both the substandard aggregate performance of the euro area since the Great Recession and the persistence of major imbalances among participating countries are a cause for dissatisfaction and concern, in Europe and beyond; although economic governance alone cannot be considered responsible for this state of affairs, it cannot escape scrutiny either. Second, the question remains whether the serious deficiencies apparent in the run-up to and during the 2010-2012 euro crisis have been fully addressed: It is not clear, whether the reformed euro area would have enough resilience to withstand another major economic or financial shock. Third, the complexity of the new surveillance system contributes to a lack of ownership by national governments and parliaments; this raises doubts about its effectiveness, especially in the context of mounting euroscepticism in many euro area countries.

On 24 October 2014, the Euro Summit agreed that ‘closer coordination of economic policies is essential’ and called for work to continue ‘to develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity’ (European Council 2014). In response, the ‘analytical note’ prepared in anticipation of the Four Presidents’ report that should be issued in 2015 lists a series of questions about the future economic governance of the euro area (Juncker et al. 2015). Pragmatic contributions to this endeavour have already started to be released (Wolff and Sapir 2015; Bénassy-Quéré and Ragot 2015). Unlike the more ambitious blueprints, they put emphasis on measures that do not require a treaty overhaul but would help improve the functioning of the EMU.

In this paper, I outline and discuss alternative possible directions for the reform of euro area economic governance. To this end, I first briefly review the reforms introduced in recent years. I then review the main shortcomings of the resulting policy system. Next, I present and analyse alternative templates for governance reform and then conclude with proposals for a practical agenda.

1. Economic governance: What has been done

In response to the global financial crisis and the euro area crisis, European policy reforms were developed on three fronts (Table 1):

a) The strengthening of preventive surveillance, both on the economic front with the already-mentioned legislation and treaty-level provisions and on the financial front with the introduction of a macroprudential oversight scheme, the responsibility for which was assigned to the European Systemic Risk Board (ESRB);

b) The building of a crisis-management regime based, on the one hand, on principles for conditional financial assistance and the provision of corresponding financing by the ESM, and, on the other hand, on the new tools put in place by the European Central Bank, especially the Outright Monetary Transactions (OMT) scheme;

c) Further systemic integration. The major initiative on this front has been banking union, which involved the assignment of supervisory responsibility to the ECB and the creation of a common resolution mechanism for banks.

Whereas the creation of the ESM and banking union were bold initiatives, the reform of surveillance has been much less radical. Reforms mainly aimed at correcting deficiencies in the enforcement of the Stability and Growth Pact (SGP) and at complementing it with non-fiscal procedures, but they fell short of an overhaul or the introduction of new and ambitious schemes.

Table 1: Main EMU reforms introduced in 2011-2013

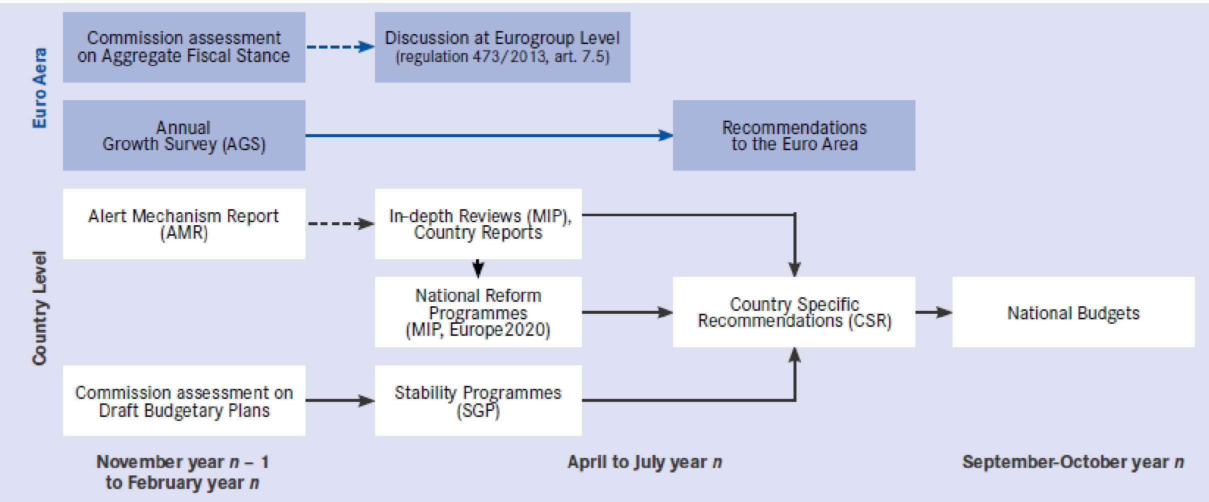
Field	Enacted reforms
Surveillance	• Reinforced treaty-based commitment to fiscal discipline [TSCG] • Strengthened preventive monitoring of fiscal developments [6-P, 2-P] • Closer surveillance of countries in financial difficulty [2-P] • New voting rules for excessive deficit procedure [TSCG] • Debt criterion for correction of excessive deficit [6-P] • Prevention and correction of macroeconomic imbalances [6-P] • Integration of sectoral procedures within the European semester [6-P] • Macroprudential oversight [specific legislation]
Crisis management and resolution	• Creation of ESM [specific treaty] • OMT programme [ECB]
Systemic integration	• Banking union [specific legislation]

Note: 6-P stands for Six-Pack and 2-P for Two-Pack.

This limitation was not because of a shortage of ideas. Academic proposals for a sovereign crisis resolution regime that would complement crisis management and define under what conditions or through what procedures the debt of an insolvent state could be restructured were put forward at an early stage (Gianviti et al. 2010; Buchheit et al. 2013), but fell onto deaf ears. Similarly, schemes for Eurobonds (Delpla and Weizsäcker 2010) or the Debt Redemption Pact of the German Council of Economic Experts (Sachverständigenrat für Wirtschaft 2011) provoked a lively discussion but were ultimately rejected. The idea to create a euro area fiscal capacity was floated in the 2012 Four Presidents' report (van Rompuy et al. 2012), and it was further detailed in a French Treasury working paper (Caudal et al. 2013), but it did not reach the stage of serious discussions. Initiatives to incentivise structural policies and integrate labour markets were considered, especially after Germany floated the idea of 'reform contracts' and France contemplated a euro area unemployment insurance scheme (Lellouch and Sode 2014), but interest in such ideas quickly faltered. Suggestions for firming up the governance institutions were made, most notably by Jean-Claude Trichet, the former president of the ECB, who called for 'federal governance by exception' (Trichet 2012), but beyond commitments to more frequent Euro Summits, no significant decision as taken in the institutional field. As to more radical proposals for federalisation (Glienicker Gruppe 2013; Eiffel Group 2014) or, to the contrary, radical decentralisation (Mody 2013), they were simply ignored.

The policy system resulting from the reforms enacted in 2011-2013 continues to be based on the same Treaty provisions but has been developed beyond the straightforward implementation of the Stability and Growth Pact in force until 2011. The system consists of a series of interlinked procedures involving fiscal and structural policies and covering both the euro area level and national levels (Figure 1).

Figure 1: A schematic representation of economic governance in the euro area



Source: Bénassy-Quéré and Ragot (2015).

It is important to note that the policy reforms introduced in 2011-2013 combine a strengthening of fiscal discipline and a broadening of the scope for surveillance and coordination. The former was introduced in response to the widespread claim that the crisis resulted from a lack of adequate enforcement of the rules of the Stability and Growth Pact. The latter echoed the view that apart from the case of Greece, it is not the lack of fiscal discipline that explained crises in the euro area, but the neglect of relative price divergence, credit developments, and current account imbalances. The case for a broadening of surveillance had actually been put forward at an early stage in an insightful but largely forgotten Commission report (European Commission 2008). It was later taken on board by the van Rompuy Task Force, whose report (van Rompuy 2010) provided the launch pad for the Six-Pack and Two-Pack legislative initiatives.

2. Shortcomings of the reformed policy system

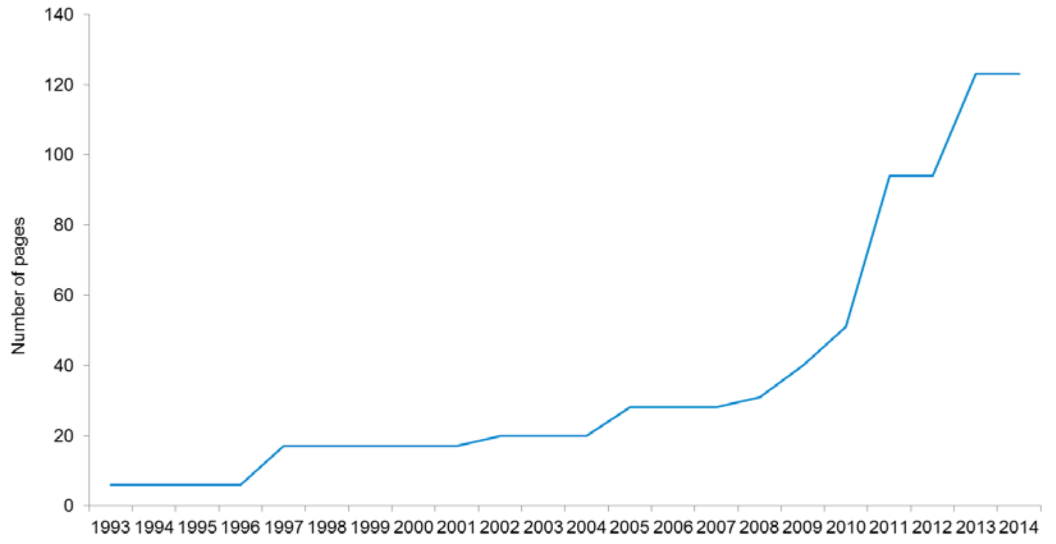
In spite of the crisis reform efforts (and in part, also, because of them), the current EMU policy system suffers from five significant shortcomings, each examined in greater detail below:

1. It has become excessively complex, which contributes to hampering its ownership by national policymakers and to reducing its effectiveness;
2. It does not favour an appropriate fiscal policy stance over the cycle. There is a risk of procyclicality and under-provision of fiscal stabilisation;
3. In spite of the Macroeconomic Imbalance Procedure (MIP), a significant discrepancy remains between the fiscal and non-fiscal dimensions of surveillance. The fiscal bias has not been corrected;
4. The Own House In Order (OHIO) syndrome still dominates policy choices and the common euro area interest tends to be underrepresented in the decisions;
5. Procedures have been strengthened, but institutions remain relatively weak.

Complexity and lack of ownership

Figure 2 depicts the increase over time in the volume of EMU secondary legislation. It unambiguously indicates that in comparison to the situation that prevailed after the introduction of the Stability and Growth Pact in 1997 and its reform in 2005, recent additions have dramatically increased the corpus of EMU-specific legislation. Provisions concerning the procedures in force now span over more than 120 pages.

Figure 2: Volume of EMU secondary legislation, 1993–2014



Source: Own computations based on EU legislation. The graph depicts the volume of legislation in force at each point in time. Secondary legislation includes the TSCG but not the EU Treaty. It does not include interpretative statements such as the Commission communication on flexibility within the Pact of January 2015 (European Commission 2015).

Beyond volume indicators, practitioners and outside observers concur that the EMU policy system has become excessively complex, and for this reason can only be mastered by a few technocrats and experts. Complexity results from the intricacy of the procedures, from the technical character of some of their provisions (as regards, for example, the measurement of structural deficits), and from their mutual entanglement. The result is that national policymakers and members of national parliaments have at best a very approximate notion of what this system exactly implies. They often perceive the EU framework as excessively procedure-driven. To use a comparison first made in the Sapir report (2003), the EU is widely seen as a policeman rather than as a facilitator.

This situation contributes to a serious lack of ownership of the reformed EU framework in the national capitals. It contributes in some countries to the perception of EU discipline as an abstruse external straightjacket.

Procyclicality and under-provision of stabilisation

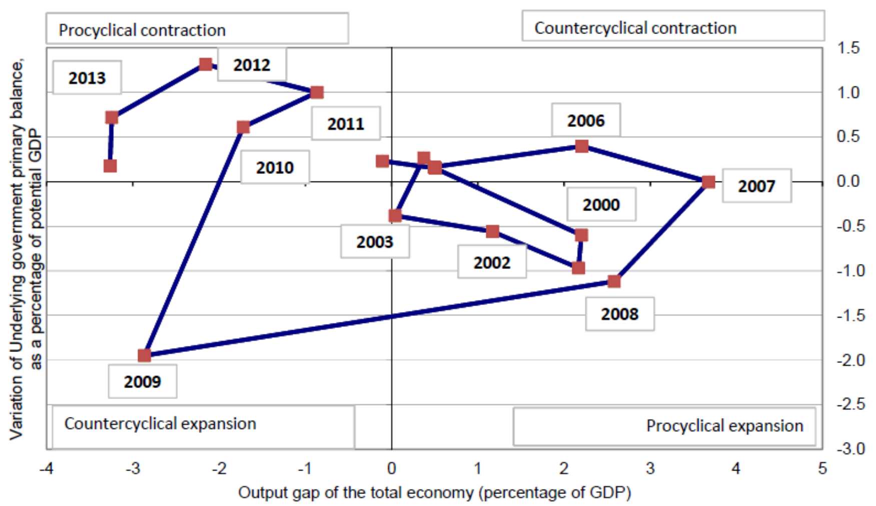
The initial Stability and Growth Pact was widely criticised for being procyclical because it was based on nominal variables only (Sapir et al. 2003). To correct this deficiency, the 2005 reforms introduced cyclically-adjusted variables, and the 2011-2013 reforms went further: The overall monitoring of fiscal positions is now based on such variables.

However, incentives to procyclical fiscal behaviour remain for two reasons: first, the 3 per cent of GDP deficit threshold for initiating an Excessive Deficit Procedure (EDP) remains defined in nominal terms by Art. 126 of the Treaty on the Functioning of the EU (TFEU). As a consequence, in a recession, member states in a still-weak fiscal position may be forced to consolidate and even those in an initially strong position may be incentivised to premature tightening for fear of passing the threshold; furthermore, cyclical corrections are themselves procyclical. Potential GDP growth for current as well as for past and future years has been regularly revised down in the aftermath of the Great Recession. This has translated into larger structural deficits and led to early corrective action, even when the economy was still in a recession or near-stagnation.

These factors come on top of a pre-existing inclination towards an under-provision of fiscal stabilisation in the EMU. This is first due to political economy reasons: Governments by themselves tend to behave procyclically, for example, by lowering taxes in an upswing. Furthermore, it is to be feared that when facing a downturn, they will be behaving even more procyclically in the years ahead: In the period 2010–2012, governments have learned from experience that market access could be lost precipitously and that even countries whose fiscal position was relatively sound could easily experience a rise in bond rates. This lesson is unlikely to be forgotten, especially as debt levels are now much higher than in 2007. For a long time governments will be mindful of reducing their deficits when recessions occur, even at the cost of causing unnecessary cyclical hardship.

Empirical evidence suggests that fiscal policy in the euro area has been almost systematically either neutral or procyclical (Figure 3): It was too lax during the boom years and too tight during the downturn years. The only notable exception was 2009, because of Europe's participation in the global stimulus.

Figure 3: Fiscal stance and the output gap, euro area 15, 1993–2013



Source: Own computations based on OECD Economic Outlook data.

Fiscal dominance

The architects of the Maastricht Treaty correctly anticipated the risk for monetary instability arising from irresponsible fiscal behaviour, but they minimised the risk posed by lasting price–wage divergence resulting in real exchange-rate misalignments. They also overlooked the possibility of balance-of-payment crises within the monetary union. The initial EMU policy regime largely mirrored this neglect and limited macroeconomic surveillance to the non-binding and essentially ineffective monitoring of non-fiscal variables within the framework of the Broad Economic Policy Guidelines.

The introduction of the MIP as part of the Six-Pack was meant to correct this neglect, but it has failed to trigger a rebalancing between fiscal and non-fiscal surveillance. The MIP involves an early warning system that may lead to in-depth reviews for countries found in significant imbalance. Its results are then included in annual Country-Specific Recommendations (CSR) and may lead to a stepping-up of the procedure, ultimately leading to pecuniary sanctions.

The MIP has however been weakened by its asymmetric character (surpluses are considered more benign than deficits), by the indirect character of the linkage between policy variables and the resulting price and current account developments (unlike a fiscal deficit, which can be corrected by an increase in taxation or a cut in public spending, governments do not have at their disposal a lever to correct current account deficits and surpluses), and by the non-automaticity of decisions (at the time of writing, the corrective arm of the procedure, called the Excessive Imbalance Procedure, has never been activated). The CSR are largely ignored in national capitals. By contrast, the enhanced SGP remains more predictable and more binding, and it involves stronger enforcement mechanisms. Its effectiveness may not be as strong as its promoters wished, but it undoubtedly influences national decision-making.

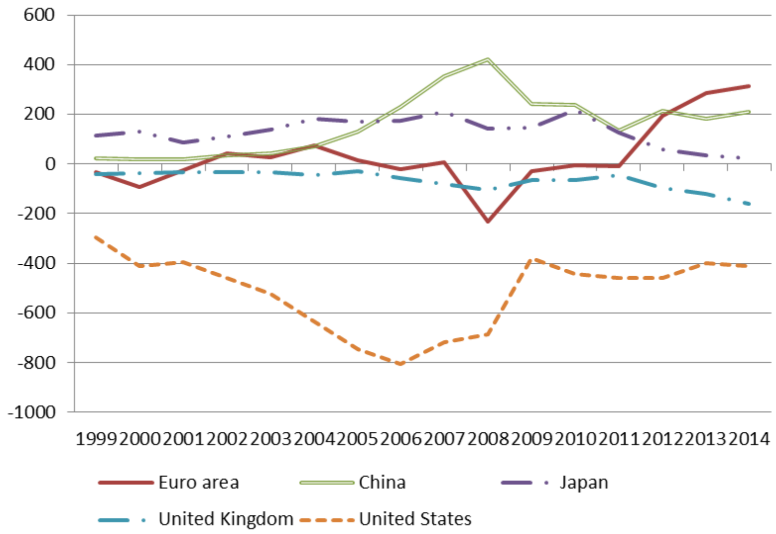
Another channel for taking structural dimensions into account is to make use of built-in flexibilities within the SGP. In its communication of January 2015 (European Commission 2015), the Commission proposed allowing deviations from the path towards a country's medium-term objective if they result from priority investments. The same would apply to major structural reforms, and such reforms would also be taken into account in setting deadlines for the correction of excessive deficits. Yet the EU policy framework remains centred on fiscal discipline. Fiscal dominance remains nearly as strong as it was before the Six-Pack.

OHIO syndrome

The European Semester framework is intended to integrate euro area-wide surveillance and country-level surveillance, so that aggregate developments and priorities are taken into account when preparing national decisions. Nevertheless, as observed by Bénassy-Quéré and Ragot (2015), a large disconnect remains between the two levels. Discussion on the aggregate situation and priorities does not result in observable action and its conclusions are not even taken into account in country-specific recommendations[1]. In practice, there is no such thing as a euro area policy stance, and the OHIO syndrome continues to dominate.

The lack of a euro-wide policy stance became very visible in the aftermath of the Great Recession when the area-wide current account started exhibiting a significant surplus (Figure 4). In 2014, the current account surplus of the euro area exceeded those of China and Japan and almost equalled in size the deficit of the United States. Whatever the concerns expressed by other countries, however, the euro area does not have any instrument at its disposal to monitor its current account and, if needed, to redress an imbalance.

Figure 4: Current account balances of the euro area, China, Japan, the UK, and the US, 1999–2014 (Billions of US dollars)



Source: IMF World Economic Outlook Database.

The case for taking cross-country dimensions into account is however strong:

– On the fiscal front, the absence of a common capacity or effective procedures for coordination makes the euro area excessively reliant on the monetary instrument (Draghi 2014b). Should monetary policy become ineffective, it would lack the ability to substitute fiscal action for monetary action. This incompleteness may not be a cause for alarm in normal times, but it could become a serious handicap in situations of acute macroeconomic stress.

(1) Bénassy-Quéré and Ragot (2015) observe that the 2014 euro area-level conclusion that current account surpluses needed to be reduced was not taken on board in the recommendations made to surplus countries. See also Hallerberg, Marzinotto, and Wolff (2012).

- On the structural front, significant interdependence makes coordination desirable, if only because structural reforms are often intended to devalue the real exchange rate (Cœuré 2014). The design of economic and social reforms is however intrinsically national and in spite of the EU procedures, governments are reluctant to coordinate their actions in politically sensitive fields.
- The euro area is a large global player but in the absence of macroeconomic mechanisms, it lacks the ability to deliver on global commitments.

Weak institutions

Apart from the ECB, whose power and legitimacy have been strengthened by the crisis, the economic governance institutions of the euro area have suffered from significant weakening. The Commission's authority has been dented by its own failings in the prevention and the management of the crisis, but also by the member states' decision not to rely on it for the provision of financial assistance to the countries in crisis.

The creation of the ESM can be regarded as a no-confidence vote for the Commission. Financially, the ESM is akin to a mutual lending cooperative that pools resources from the member states and puts them at the disposal of the Eurogroup for use in conditional assistance. From an institutional standpoint, it is based on new principles and procedures that make it the embryo of an alternative governance system.

At the same time the Eurogroup, whose remit was to coordinate national policies in the common interest, has paid a price for not having been able to prevent major economic and financial imbalances. Furthermore, during the height of the crisis, the Eurogroup was deprived of virtually all its powers by the direct handling of all important crisis management decisions by the Euro Summit. It is only in the post-crisis implementation of the SGP that it has regained a role.

The euro area has therefore emerged from the crisis with a series of feeble economic and financial institutions: a weakened Commission; an ESM whose remit is limited to the mere provision of funding; and a Eurogroup whose authority is disputed and that lacks the machinery that could help turn it into an effective policy body. Furthermore, the involvement of the IMF and the ECB in the Troika and the implications it has for countries under financial assistance and for the overall policy priorities of the euro area further complicate the situation.

This state of affairs is an impediment to the proper democratic legitimacy of the euro area institutions. First, the multiplicity of institutions and their overlapping responsibilities do not make it possible to hold any of them accountable for policy outcomes: It would be hard to determine, for example, who should be held responsible for a possible failure in Greece. A 'Who Lost Greece?' question would undoubtedly give rise to extensive soul-searching in the EU that would, for example, highlight that the Commission as a college never took responsibility for the Troika-monitored programme and that, although the ECB is part of the Troika, it is not part of the MOUs[1] that result from the programme negotiations. Second, there is no single body to which euro area policy players are accountable: The European Parliament is the relevant body for some decisions, for example, the implementation of the SGP, but for other decisions, such as the provision of conditional financial assistance, the responsibility rests mainly with the national parliaments that voted on the corresponding resource commitments. This represents a serious obstacle to proper democratic control.

3. The way forward: Choices

Whereas the need for further reforms of the euro area is widely acknowledged, discussions in the EU tend to focus on whether they imply treaty amendments. Accordingly, the yardstick of ambition (or, conversely, of realism) tends to be assessed on this basis.

A focus on changing treaties is beside the point. Whether treaty amendments are needed will be an important issue once euro area members have agreed on a roadmap for the future, and it is certainly not a minor issue in the context of British calls for renegotiation and popular dissatisfaction with the way the EU is run. But to make it the centre of the agenda is to put the cart before the horse. What Europe needs is first and foremost a shared vision of the direction in which the euro area should evolve and the type of institutions it requires. At what speed the resulting programme should be implemented, and whether or when treaty revisions will be needed are important questions, but they can only be addressed in a second stage.

This is even truer in the current context, because rival interpretations of the root causes of the euro crisis of 2010-2012 and the corresponding remedies prevail. Throughout Europe, conflicting crisis narratives put forward by public intellectuals have captured the minds of citizens and influence policymakers. Like after the failed Franco-British Suez intervention of 1956, from which France concluded that it could not afford to rely on US support in its foreign policy initiatives, and Britain that it could not afford not to rely on it, the same traumatic experience gives rise to sometimes opposite conclusions. This is what makes a shared vision of the future so important, and so difficult to define.

There are basically three competing models of the euro area of the future (Table 2). The first is a fully decentralised model, the second a federal model, and the third a hybrid one.

(1) Memoranda of understanding.

Table 2: Alternative models for the future of the euro area

	Discipline	Solidarity	Governance	Legitimacy
Fully decentralised model	Strict no-bail out, maximum exposure ceilings for banks	No euro area-specific solidarity	Insolvency procedures for sovereigns	No specific accountability
Federal model	Rules and procedures for fiscal and macroeconomic surveillance	Countercyclical transfers and conditional assistance financed by common budget	Federal institution (presumably Commission) as euro area executive	Accountability to European parliament
Hybrid model	National rules consistent with common principles, network of national institutions	Graduated mutual support mechanism	Euro-area coordination executive	Parliamentary body built out of national parliaments and the EP

Source: partially adapted from France Stratégie (2014).

The first model corresponds to a minimal monetary union where governments are free to behave as they wish as long as they bear the consequences. In this model, which has been proposed by, for example, Mody (2013), irresponsible fiscal behaviour ultimately results in a sovereign bankruptcy, for which there should be a procedure. Banks are protected from such irresponsibility, through banking union and the setting of ceilings to bank exposure to the default of any particular borrower. Nations and governments are treated as adults: They are expected to be aware of the risks, to know the rules, and to understand that they will not be rescued by their neighbours.

Because it keeps common requirements at minimum level, this fully decentralised model provides a useful intellectual benchmark for thinking about the structure of monetary union. Its proponents claim that it is in fact very close to that of the modern-day US: Whereas states in trouble after the Independence War were supported by the federal government, a strict no bail-out principle emerged in the mid-19th century (Henning and Kessler 2012).

The problem, however, is that the political and financial viability of this model are both open to question. Politically, an implicit quid pro quo to the renunciation to monetary sovereignty has been that member states could count on support and solidarity from their neighbours in case of severe adverse shocks. Exclusion of such support would amount to a rewriting of this contract. Financially, the model is furthermore hardly accessible to the EU, because it would require much lower levels of public debt in the member states. The public debt of Italy amounts to nearly 20 per cent of the aggregate GDP of the euro area, whereas that of California represents less than 3 per cent of the US GDP. An Italian bankruptcy would be a financial disaster for the EU, whereas for the US a Californian bankruptcy would be a more absorbable one. A strict no-bailout clause, interpreted as excluding any form of cross-country support, is therefore not credible.

The second, federal model does not require much presentation. It implies a common budget for the euro area, the strengthening of executive role of the Commission, and accountability to the European Parliament (EP). In short, the Commission would become the embryo of a federal government equipped with a budget and accountable to a parliament. Evidently, this would remain a very decentralised federation in comparison to existing federal states. But the logic would be similar: For the euro area to function properly, Europe should get closer to the true federation its early architects had in mind.[1]

The difficulty with this approach is however threefold. First, it has lost credibility. To start with, there is currently very little appetite politically for transferring more powers to Brussels. The notion that a better functioning monetary union necessarily implies more Europe is alien to many of the coalitions in power in the continent's capitals. Furthermore, the Monnet logic, according to which each crisis in the EU should serve as an opportunity for further integration[2], has reached its limits. Citizens cannot be told after each crisis that the reason why the EMU is dysfunctional is that too little power has been transferred to the EU. As documented by Guiso, Sapienza, and Zingales (2015), European citizens still believe in the European currency, but have no appetite for delegating more powers to the federal level.

This does not imply that any form of integration must be ruled out, if its necessity is demonstrated: In 2012–2013, agreement on creating a banking union was remarkably swift, including within the UK, because it was convincingly argued that the initiative was indispensable to safeguarding the integrity of the euro area. But crises cannot be used anymore as a mere pretext for promoting an integration agenda.

Second, federalisation would not solve the basic issue which is that a country's fate within a currency zone largely depends on its own economic choices. Allocating further responsibilities to the federal level would not make this fate less dependent on domestic behaviour. Labour market and R&D policies would still be key for competitiveness, the behaviour of the budget balance over the cycle would still be key for stabilisation, and public spending choices would still be key for the sustainability of public finance. In other words monetary union cannot be regarded as the mere transfer to the European level of specific sectoral competences. The analogy between, on the one hand, market integration through the removal of obstacles to microeconomic integration and the establishment of common regulations and, on the other hand, policy integration in the context of a common currency zone, is a flawed one.

Third, unlike market integration, policy centralisation, which is complete for monetary policy and deep in related fields such as banking supervision, may call for more national autonomy

(1) I do not discuss here whether such a federation should be built around the euro area, the EU as a whole, or a coalition of the willing within the EU. This is an important question but not the focus of this paper.
(2) Monnet (1976) writes in his memoirs, 'J'ai toujours pensé que l'Europe se ferait dans les crises, et qu'elle serait la somme des solutions qu'on apporterait à ces crises' ['I always thought that Europe will be forged in crises, and will be the sum of the solutions adopted for those crises'].

in other fields. This is because the unavailability of an individual monetary response to shocks calls for keeping other instruments such as fiscal or tax policy at the disposal of member states. As long as national economies remain heterogeneous, centralisation in one field may actually call for decentralisation in another one.

What is lacking in some fields is therefore less a centralisation of decision-making than an internalisation by national policymakers of the constraints that arise from participating in a currency union. For example, what was missing in the first decade of the euro was first and foremost consciousness of the long-term implications of the currency regime for, say, wages and prices, taxation, and the sustainability of public finances. It is not primarily because governments did not behave uniformly that countries got into trouble; it is because they did not behave in accordance with the discipline their countries had explicitly or implicitly subscribed to. Lack of coherence mattered more than lack of similarity.

The same applies to the fiscal field: More coherence in the use of national policy instruments does not imply centralisation. The management of a common currency might be facilitated by a common budget, but—whatever the likely size of the EU or euro area budget in the years to come—it will remain very small in comparison with national budgets. What is required is that public finances be managed in a way that is coherent with the sharing of the currency. In the same way, centralised wage-setting is not desirable; rather, what is needed is an adaptation of national or subnational wage-setting institutions to the interdependence created by the sharing of the currency.

Against this background, the euro area should combine more integration or centralisation in some fields with more margins for manoeuvre in other fields. It should also combine these traits with incentives to coherence with common requirements and discipline.

4. A practical agenda

These observations provide guidance to think about the third, hybrid model—a model that draws on recent evolutions and combines centralised and decentralised features.

Fiscal institutions

In order to remedy the deficiencies discussed above, a first requirement is to streamline the fiscal surveillance system, which has become much too complex. As indicated, the way forward is to decentralise the corresponding discipline, while keeping the requirement that national policies be consistent with the principles of monetary union.

The euro area's crisis response has actually opened the way to such an evolution. The TSCG provision that mandates the adoption of fiscal rules at national level and the creation of a fiscal council in each member state represents a significant shift towards decentralisation. It is an attempt to foster domestically-rooted fiscal responsibility rather than a discipline imposed top-down by EU procedures. Fiscal councils are part of the national policy system, they speak the same language as national policymakers, and they are able to intervene in real time in the preparation of the stability programme and the budget. At the same time their mandates are consistent with the overall principles governing fiscal responsibility in the EU and the euro area. For this reason they are well-placed to contribute to the required policy coherence. It is certainly very early to assess the effectiveness of these new institutions, but anecdotal evidence suggests that they may already have had an impact on policy choices.

This evolution should be pushed one step further. First, the remit of the fiscal councils should be broadened to encompass the forecast of tax receipts, the costing of tax and spending measures, and debt sustainability analysis. Some of them have already been assigned such responsibilities, but not all.

Second, a similar council should be built at the euro area level, which would—following the template offered by DG Competition and the national Competition Authorities—provide a hub to the network of national fiscal councils. This euro area council, which would be located within the Commission but should enjoy the same degree of independence as its national counterparts, would help foster exchange on best practices and develop common methodologies and instruments. Unlike the Commission's DG ECFIN it would however not be in charge of enforcing discipline.[1]

Third, governments should also be encouraged to rely more on the independent expertise of these committees, and this could be done by granting countries equipped with better and more credible domestic institutions more margins of manoeuvre within the framework of the SGP. For example, temporary deviations from the medium-term objective should be more easily allowed for countries with better institutions. This would give governments a major incentive to invest in domestically-rooted fiscal discipline and set in motion a move towards decentralisation.

Economic institutions

Competitiveness councils could also be formed on the same model. Their role would be to monitor developments in real exchange rates, current accounts, and non-price competitiveness and to provide recommendations to national governments and social partners for wage-price evolution, taxation, and non-price competitiveness enhancement measures.[2]

Again, such institutions would be much better placed than the EU to formulate recommendations. Because they would be part of the domestic discussion and in contact with all players, their assessments and recommendations could be much more timely and fine-tuned or granular.

The network dimension would be especially important here, as competitiveness is largely a relative property. To avoid systematic biases towards deflation or, conversely, inflation, it

(1) The initial idea for a network of fiscal councils was laid out in Sapir et al. (2003).
(2) Similar ideas have been put forward by Wolff and Sapir (2015) and Bénassy-Quéré and Ragot (2015).

would be crucial to ensure that methodologies used to evaluate real exchange rate misalignments in participating countries are mutually consistent.[1]

Solidarity

Solidarity is a natural counterpart to discipline (which is why the fully decentralised model involves neither), but it may take different forms. In a model built around cooperation between participating countries, it would logically not take place through transfers financed by a common budget, at least not primarily. Rather, it would take the form of graduated mutual financial support. This is already the case with conditional lending by the ESM and the ECB's OMT programme, but there is discontinuity between the normal situation (in which a state gets no support whatsoever) and the programme situation (in which it has to subscribe to harsh conditions). As indicated already, a 'fear of the Troika' syndrome has developed that may result in a very procyclical behaviour of indebted governments facing an economic downturn.

Instruments should be created for a more gradual approach to mutual support. This could imply low-conditionality lending as with the recent IMF facilities, whose aim is to discourage excessive reserve accumulation by countries fearing capital flows reversals. An alternative would be a scheme such as that suggested by Enderlein et al. (2012): States would in a first stage be granted unconditional access to a buffer of mutually guaranteed borrowing and gradually move to more conditional types of financing, until a point where they would be compelled to subscribe to a conditional assistance programme—the last step before a formal bankruptcy and the ensuing restructuring of public debt, for which a procedure should also be put in place. A system of this sort would offer more gradation and continuity. By providing predictability to the individual member states, it would also help counter the risk of an under-provision of stabilisation. Instead of substituting national stabilisation with euro area-wide stabilisation, the system would aim to support the national level and thereby make it effective.

Naturally, such a policy regime would require a strengthening of fiscal discipline. Access to a mutually guaranteed borrowing buffer could not be granted without significant guarantees, including a potential EU veto on the national budgetary decision of the states that draw on this buffer.

Fiscal capacity

Whereas the need for stabilisation should be addressed by making participating states more able to cushion shocks through their own fiscal means, this response would not eliminate the need for an aggregate fiscal capacity. There are two reasons why it would still be needed—one macroeconomic and one financial.

(1) A similar approach also applies to credit policies, which are outside the remit of this paper.

With the creation of the ESM, the euro area as a whole has been given the means to finance exceptional assistance to countries in trouble. As indicated already, similar common requirements may arise from the need to provide the fiscal support of last resort in situations of acute stress. Again, there could be two ways to organise it: either through coordination—which would require creating a formal mechanism that would make it possible in exceptional circumstances to take, by qualified majority, the decision to mobilise national fiscal means—or by giving the euro area the possibility to borrow in predefined special circumstances. Either would be a significant innovation.

A common fiscal capacity would also be needed in the hopefully rare case when bail-in mechanisms and the recourse to the insurance scheme financed by the banking industry would not be sufficient to address the financial consequences of a bank failure. A contingent mechanism to remedy such situations would not imply any permanent tax resource but it should make it possible to mobilise it, should the need arise.

The important point about the fiscal capacity is that it should not be understood as an instrument for cyclical stabilisation. Cyclical stabilisation needs and exceptional crisis-management needs are of a different nature, and they may be responded to in different ways. Whereas the former can (and in my view should) be addressed through restoring the individual states' stabilisation capacity, the latter involves significant collective action dimensions and requires a specific common mechanism.

Governance institutions

Institutional reform should also be put on the agenda, for two main reasons. First, such reform is necessary to ensure a better representation of the common euro area interest. Governments essentially speak in the name of the national interest, and the voice of the common interest is too muted. Second, the current governance system is weak and wobbly: The president of the Eurogroup is in charge of coordinating national policies, but s/he is not supported by a bureaucracy and does not have coordination instruments at his/her disposal; the Commissioner for economic and monetary affairs does have a bureaucracy to rely on, but is bound by the existing procedures and can only issue recommendations. This dual system is well-suited to the preparation of legislative proposals but not to the exercise of executive powers. Its weaknesses have been displayed throughout the euro crisis.

There are basically two alternative solutions to strengthen the governance machinery of the euro area. One is to equip the Eurogroup with a full-time president and professional services, presumably building on the ESM. This is what is intended by the proponents of a 'European Treasury'. Such an arrangement would have the advantage of addressing the executive deficit but at the cost of creating a two-headed governance system with two potentially rival bureaucracies—the Commission and the European Treasury. The alternative would be to adopt the template in use for the High Representative for Foreign Affairs and Security Policy: to let the Eurogroup be chaired by the ECFIN commissioner. This 'double hat' solution would necessarily require giving to a separate person and a separate body the fiscal and economic watchdog role currently assigned to the ECFIN commissioner, because the same commissioner cannot simultaneously play the procurator and the judge. It would be consistent with the creation of a fiscal council at European level. National capitals might be reluctant to grant additional powers to the Commission, but a divided executive is not a very attractive prospect either.

Legitimacy

Because they would clarify what belongs to the EU and what belongs to the national level, reforms of the type discussed in this paper would help strengthen democratic legitimacy. The appropriate way to organise it would however depend on the structure of economic governance. As long as resources mobilised in assistance or coordination processes come from the EU budget or a potential euro area budget, accountability should be to the European Parliament. However, if resources do not come from a federal budget but from the national parliaments, they should be involved in the accountability procedures. This would require establishing a parliamentary body that would draw on national parliaments as well as the EP.

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