TOWARDS A BETTER GOVERNANCE IN THE EU?

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The 10th EUROFRAME[1] Conference on economic policy issues in the European Union was held in Warsaw on 24 May 2013. The Conference topic was: "Towards a better governance in the EU?". Twelve of the papers given at the Conference are released in this issue of the *Revue de l'OFCE/Debates and Policies*.

The euro is a unique experience in modern economic history. Can a single currency be shared between countries with different cyclical situations, structural problems and economic strategies? Is a single currency consistent with independent domestic fiscal policies? In 1992, EU countries answered 'yes' to these questions by signing the Maastricht Treaty. Starting from then, euro area governance was characterized by independent domestic fiscal policies however constrained to fulfil several criteria (public deficit below 3% of GDP, public debt below 60% of GDP), a single monetary policy entrusted to an independent central bank, the absence of public debt guarantee and fiscal solidarity between member states.

This framework was a failure. Prior to the crisis, disparities widened between member states (MS), northern countries taking advantage of fixed exchange rates to implement policies aiming at gaining competitiveness and increasing external surpluses, at the cost of strong wage and social austerity and low growth, while southern countries were taking advantage of low interest rates to enjoy a strong growth, based on housing bubbles and leading to an unsustainable external deficit. The European Commission and the MS were not able to implement a satisfactory economic policy. The European Commission pursued

1. EUROFRAME is a network of ten independent European research institutes: WIFO (Austria), ETLA (Finland), OFCE (France), DIW and IFW (Germany), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland), NIESR (United Kingdom).

endless efforts against countries with higher than 3% of GDP deficits without seeing that the danger was coming from rising external deficits in Southern countries and more generally from financial and housing bubbles.

The world financial crisis was followed in Europe by a sovereign debt crisis in euro area countries, when financial markets realised that these debts were no more safe assets. Investment funds' fears and speculation from many financial bodies widened interest rates disparities in Europe and weakened the single currency notion, since now euro area companies do not borrow at the same rate depending on their location.

European institutions and MS states tried to tackle the crisis in setting up new rules and institutions:

— Fiscal discipline was strengthened through the six-pack, two-pack and the fiscal compact. But we may argue that the current crisis is not due to fiscal indiscipline. The measures and mechanisms introduced since the beginning of the crisis strengthen rules lacking economic rationale and prevent from implementing appropriate fiscal stabilization policies. They will probably be unenforceable.

— Member states were constrained to fulfil the Stability Pact, through implementing fiscal austerity policies from 2011, in a situation of economic recession and mass unemployment. These policies brought the economic recovery underway to an end and plunged the euro area in depression again in 2012-13. Southern economies reduced their external imbalances, although through falls in domestic demand and output, and large increases in unemployment rates. Today these countries seem to be deprived of any economic and social dynamism. In 2013, the euro area had lost almost 10 percent of GDP due to the crisis, without the EU institutions recommending any economic recovery strategy, outside fiscal austerity and liberal structural reforms, strategies which have failed so far to bring the euro area out of the crisis.

— The surveillance of MS economic policies was strengthened and broadened through the introduction of a first European semester and of the macroeconomic imbalance procedure, without any true MS economic policy coordination.

— Solidarity mechanisms between MS were introduced (EFSF, EFSM, ESM), the central bank intervened (SMP – securities market programme) or announced it would be ready to do so if needed (OMT programme). But the price of solidarity was high

for countries agreeing to receive support from the Troika, and this did not restore public debts unicity in the euro area.

— EU institutions now advocate further steps towards federalism in banking or fiscal areas (automatic transfer mechanisms, EU common unemployment insurance system).

In May 2013, when the EUROFRAME Conference was held, the euro area seemed to be saved, speculation had calmed down, but growth had not resumed and southern economies were remaining depressed without clear improvements prospects. Was the euro area saved at the expense of member states?

A variety of analyses were expressed at the EUROFRAME Conference, like in the EU debate:

— According to some authors, Europe should stick to the original Treaty, abolish solidarity mechanisms, prevent the Central bank to buy MS government bonds, make it compulsory for governments to issue bonds on financial markets. But is this consistent with the single currency? Do markets have expertise in macroeconomic areas? Should euro area countries be considered as countries without monetary sovereignty and issuing risky public bonds?

— Other authors consider that Europe should move towards a federal Europe, where European authorities would be responsible for fiscal policy at least for the stabilisation component, but also more in more in incentives and allocation functions (redistribution being so far not considered). This requires more democratic instances in the EU and possibly some form of political union. But can countries with different economic conditions, different economic and structures, be managed centrally? The euro area is too heterogeneous. Can each county agree to submit its domestic social and economies choices to European trade-offs?

— Some authors consider that public debts should become safe assets again, guaranteed by the ECB, within a real economic policy coordination process within MS, targeting explicitly full-employment and the reduction of imbalances in the area. Is such a co-ordination a myth? Can a country agree to modify explicitly its economic policy objectives so as to help improve its partners' economic situation? Is the lack of trust between EU countries too strong to allow each MS to guarantee its partners' public debts?

— Last, according to some other authors, a single currency cannot be shared by too heterogeneous countries; unconditional debt

guarantee will be refused by Northern countries, even though it is a prerequisite to maintain euro area unity; Europe is unable to organise a common but differentiated strategy; that differentials accumulated in terms of competitiveness require large exchange rate adjustments in Europe. Exchange rates variations should remain possible to reflect disparities between MS: strong exchange rate falls in southern countries, strong rises in northern countries. Each country should face their own responsibilities: Northern countries will have to raise domestic demand; Southern economies will have to use their competitiveness gains to rebuild an export-oriented sector.

Therefore, the advocates of the single currency have to make a choice. Can governance in the euro area be designed in a way which would strengthen the economic robustness of the area, would give MS the rooms for manoeuvre needed within a coordinated economic strategy, albeit forbidding both excessive competitiveness gains and excessive rises in debts or deficits? How to strengthen the economic and monetary union between remaining heterogeneous economies? How to bring the economic and financial crisis to an end, with the implementation of a euro area governance while allowing member states to follow economic policies adapted to their needs?

EU governance

In "**The Fiscal or Bailout Union**: *Where Is the EU/EMU's Fiscal Integration Heading*?", Marek Dabrowski criticises the view according to which closer fiscal and political integration is a condition for the common currency to survive. The author recalls that the EU is based on the principle of subsidiarity. The author refuses fiscal federalism, eurobonds or lender of last resort facility, which would lead to moral hazard behaviour. The author advocates a return to the Maastricht principles: enforcing fiscal rules, no bail-out and market discipline.

The paper by Catherine Mathieu and Henri Sterdyniak: "**Redemption?**", recalls that, before, during and after the crisis, euro area governance was not satisfactory. The paper shows that the problem is not a lack of fiscal discipline in Europe, but general drifts in financial capitalism and an inappropriately designed euro area economic policy framework (non-guarantee of public debts, no real economic coordination, and liberal strategies to impose lower social public expenditure and structural reforms). EU member states should not be requested to pay for past sins through austerity measures, and should not strengthen fiscal discipline through rules lacking economic rationale. The paper criticizes recent proposals made with a view to improve euro

area governance (redemption fund, European debt agency, fiscal federalism). European public debts should become safe assets again, and should not be subject to financial markets' assessment. The paper advocates for a full guarantee of government bonds for the member states commit to an economic policy coordination process, which should target GDP growth and coordinated reduction of imbalances.

The paper by John FitzGerald: "**The new EU governance arrangements**" recalls that the fiscal rules of the Stability and Growth Pact were not effective before the crisis. They did not prevent some MS to maintain an economic strategy whose drawbacks were revealed by the crisis. Some drawbacks of euro area governance were corrected since the beginning of the current crisis. However John FitzGerald is critical on the methods used to estimate potential output and how they are used to assess MS fiscal policies. The author considers that when output is significantly below or above potential, a counter-cyclical policy should be undertaken at the euro area level, but also that in normal times, member states may be able to choose their own fiscal policy.

The paper by Paolo Onofri and Tsvetomira Tsenova: "**Engine for European growth and stability**" explains that EMU faces a critical trilemma: a slow death by asphyxiation, a sudden collapse or a new building yard for EMU, which supposes an efficient implantation of the banking union, a grace period to enable peripheral countries to restructure and contribute to the European recovery, and institutional reform to allow public debts to become again risk-free assets.

Fiscal policy in the EU: Some Assessments

In the paper "**Primary balance and debt projections based on estimated fiscal reaction functions for euro area countries**", Martin Plödt and Claire Reicher use fiscal rules based on estimated fiscal policy reactions functions to project the path of public debt and primary balances for bigger euro area countries. The paper shows that Italy will need an extremely high primary public surplus to succeed to rapidly reduce its debt/GDP ratio; the situation is less worrying for Germany, Spain and France. A more rigid fiscal rule like the "1/20" rule may destabilise the economy, as restrictive fiscal policy may increase the debt ratio in the short time. The required policy strongly depends on the potential growth projections, which is problematic for some countries like Spain (or Ireland or Greece).

The paper by Matti Viren: "**How different are the fiscal policy effects?** *Assessing the importance of cyclical situation, policy coordination, composition of policy measures and country specific features*" uses different

methods to estimate fiscal policy effects. It appears that fiscal multipliers depend on countries, are larger for bigger than for smaller countries, larger also during economic recessions, and larger for euro area generalized policies, especially for smaller countries. These effects are to be taken into account when a fiscal coordinated policy in considered.

The paper on "**Fiscal consolidation in times of crisis: is the sooner really the better?**" by Christophe Blot, Marion Cochard, Jérôme Creel, Bruno Ducoudré, Danielle Schweisguth, and Xavier Timbeau gives a survey of the recent literature which rediscover, after the monetarist, rational-expectations, DSGE models counter-revolutions, that the fiscal multiplier is positive, is higher in periods of high unemployment and low level of capacity utilisation, higher when a zero-lower-bound constrains monetary policy, higher for expenditures than for taxes. Using a small model of euro area countries, where the multiplier varies according to the output gap, the authors show that implementing large fiscal austerity policies in a depressed economic context is costly and inefficient. It would have been better to postpone fiscal consolidation in the euro area until a period where MS output gaps are less negative. However we can note that such a strategy would require a strong confidence between the MS, the ECB and financial markets: the ECB would have to accept to guarantee MS public debts, financial markets would have to refrain from speculating on MS commitments to reduce their debt in the future.

Governance and Banking issues

The paper by Maylis Avaro and Henri Sterdyniak: "**Banking union: a solution to the euro zone crisis?**" analyses this new project expected to help to solve the euro area crisis. The banking union would break the link between the sovereign debt crisis and the banking crisis, by asking the ECB to supervise banks, by establishing common mechanisms to solve banking crises and to guarantee deposits. The article expresses the fears that banking union is a new and uncontrolled step towards more technocratic federalism. Structural choices on the European banking system will be left to the ECB. Banks' solvency and ability to lend would depend primarily on their capital ratios and thus on financial markets' sentiment. The links between the government, firms, households and domestic banks would be cut. The paper suggests that banking union should be accompanied by the introduction of a tax on financial activity and by isolating retail banking activity from risky activities.

The paper by Ewa Miklaszewska, Katarzyna Mikołajczyk and Małgorzata Pawłowska: "**Do safe banks create a safe system?** Central and Eastern European banks' perspective" describes banks' situation in the CEE-5. In the CEE-5, banks remained in the traditional model of banking intermediation, they were not strongly hit by the financial crisis and did not need fundamental restructuring. Nevertheless, the banking union will establish complex new rules and regulatory bodies, which may increase moral hazard behaviour, bank concentration, away from the CEE stable and healthy banking model.

Macroeconomic issues

Paavo Suni and Vesa Vihriälä, in: "**Euro – How big a difference: Finland and Sweden in search of macro stability**" compare the economic developments in Finland (which in the euro area) and Sweden (which decided not to join the euro area). It appears that Sweden has achieved a better price stability improvement and a better resistance to the global shock in 2009-10, due to its independent monetary regime. Nevertheless, part of the recent bad performance of the Finnish economy is due to a specific factor: the decline of the Nokia cluster.

The paper by Hubert Gabrisch and Karsten Staehr: "**The Euro Plus Pact: Competitiveness and external capital flows in the EU countries**" analyses the relationship between competitiveness, trade balances and capital flows. Contrary to the prevailing opinion according to which competitiveness differentials generate differentials in trade balances which should be financed by capital flows, the paper gives econometric results showing that there is no obvious causality between competitiveness and current accounts, and conclude the opposite: countries attracting external capital flows in a monetary union will see increases in their wages and prices, and consequently competitiveness losses and current account deficits. This leads the authors to be critical about the surveillance of unit wage costs introduced in the euro plus pact. Does this mean that wages should have risen in Spain (to lower domestic companies' profitability) and that wages should have decreased in Germany?

The paper by Margit Schratzenstaller: "**Reform Options for the EU's System of Own Resources**" shows that fiscal procedures currently used to build the EU budget lead each member state to account for their financial rewards only instead of supporting projects benefiting the whole EU. This could be corrected via allocating own resources to the EU. The paper discusses which taxes could become immediately EU based (financial transactions tax, financial activities tax, flight tax, tax on carbon dioxide emissions, tax on energy, CIT, VAT).

Our conclusion

The financial crisis and the debt crisis are major challenges for the euro area. There is clearly a need to improve euro area governance. Several mechanisms have been introduced since 2010. They failed so far to bring the euro area out of recession: they widened disparities between member states and among citizens. Europe has become unpopular, is seen more and more as running blind and inappropriate austerity policies, undermining social protection, under technocratic and distant governance. We do not think that European construction should be abandoned, that it should be weakened in abandoning the single currency. But Europe should strengthen as a "champion of world governance", against the domination of finance, promoting the social model, and taking the leadership against climate change and favouring environmental transition. This cannot be done as long as Europe remains a low growth area, leaving southern economies in recession. The implementation of a new governance in the euro area requires both institutional changes (public debts should become safe assets again, economic policies should be truly coordinated) and new targets: growth, employment, social standards. This requires restoring a certain degree of confidence and solidarity between member states and citizens; launching new European big projects, like social Europe or green Europe, economic recovery in southern economies, catching up in central and eastern countries. Further steps towards a political union may be taken only once peoples' confidence in Europe has been restored.

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