IN SEARCH OF A BETTER GOVERNANCE IN THE EURO AREA

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The 2007 crisis highlighted the drawbacks of the euro area framework which were already there from the launch of the single currency. There cannot be a single currency between countries with different economic situations and independent economic policies. Euro area governance (no public debts guarantee by the ECB, arbitrary rules focusing on public finances only), was not satisfactory. EU institutions tried to impose a strategy (domestic policies constraints, public deficits cuts, liberal structural reforms) which failed. Before the crisis, imbalances had risen between Northern Member States (MS) and Southern MS, and became unsustainable with the crisis.

The Fiscal pact strengthened rules lacking economic rationale. Blind austerity policies led the euro area to fall in depression and undermined euro area cohesion. The procedures implemented strengthen economic policy surveillance between MS, without organising real domestic economic policy coordination. They allow for limited solidarity, at a very high price. Fiscal federalism projects cannot offset the loss of independence for domestic economic policies.

MS Public debts should become safe assets again, thanks to the ECB's guarantee. This requires implementing real economic coordination, which should target growth, full-employment and orderly reduction in imbalances between MS. Europe should reaffirm its specificity: a social model, a will to prepare for ecological transition. These are prerequisites for Europe to make progress.

1. A framework with original drawbacks

The rise in imbalances between MS from 1999 to 2007, and the 2007 crisis highlighted the drawbacks of the euro area framework. EU institutions and MS have been unable to implement a common economic strategy, and not even a satisfactory economic policy co-ordination. The single currency suffers from six original sins:

— According to economic theory, there cannot be a single currency between countries with different economic situations and independent economic policies. The single currency entails introducing precise, well-defined and binding constraints, solidarity mechanisms or economic policy coordination. How to prevent otherwise the emergence and persistence of imbalances between some countries running large external deficits and some others running large surpluses?

— These mechanisms cannot consist in rigid numerical rules, lacking economic rationale, and enshrined in a Treaty. These mechanisms should be both soft (economic policies should be agreed between countries accounting for current domestic economic contexts) and binding (everyone must comply with decisions agreed in common). But how may governments with necessarily different interests and analyses agree on economic policy strategies? How to convince a country to modify its economic policy in order to meet common rules?

— There cannot be unconditional solidarity between countries with different and autonomous policies. For example, Northern countries may refuse to support Southern countries, blaming them for not having undertaken the necessary structural reforms, for having let imbalances grow and for being unable to meet their commitments. On the other hand, such solidarity is a prerequisite for the single currency to be guaranteed.

— According to the EU Constitution, the ECB is not entitled to finance directly governments (Article 123); financial solidarity between MS is forbidden (Article 125). Thus, each MS must borrow on financial markets without any guaranteed support from a central bank acting as a "lender of last resort". This raises the risk that some MS may not be able to fulfil their commitments and may default. MS public debt is no longer a safe asset. Contrary to the US, the UK or Japan, euro area countries have lost monetary sovereignty. Financial markets started to realise this from mid-2009. After the Greek default, they requested excessive interest rates to countries in difficulty, which increased further the difficulties of the latter.

— Euro area MS are now under financial markets' surveillance and they do not control anymore their interest rates unlike Anglo-Saxon countries or Japan. But financial markets have no macroeconomic expertise, they are – and know that they are – self-fulfilling. However, Northern countries refuse a collective guarantee of MS public debts. They consider the discipline imposed by financial markets to be necessary. But disparity among interest rates is arbitrary and costly. In the long term, for instance, a country like Italy, with a 2 percentage points interest rates spread with France, would pay financial markets a premium of around 2.5% of GDP as a guarantee to an alleged default risk. The single currency notion disappears: a Spanish company does not borrow at the same interest rate as a German company.

— The Commission, the high EU and domestic administrations are currently dominated by a federal, liberal and technocratic ideology. According to this ideology, Europe should deprive democratic countries (subject to demagogic temptations) from their powers to move towards a liberal model: tax cuts, social and public spending cuts, structural reforms, market deregulation.

Before the crisis, imbalances rose between two groups of euro area countries implementing two instable macroeconomic strategies: Northern countries (Germany, Austria, Netherlands, Finland) were basing weak growth on competitiveness gains and huge external surpluses while strong growth in southern countries (Spain, Greece, Ireland) was driven by negative real interest rates below GDP growth, and was accompanied by housing bubbles and large current account deficits (see Deroose *et al.,* 2004, Mathieu and Sterdyniak, 2007). In 2007, the Netherlands and Germany ran current accounts surpluses larger than 8% of GDP, Portugal, Spain and Greece were running current account deficits larger than 8% of GDP. The economic policy framework introduced by the Maastricht Treaty, based on the single control of public deficits was unable to prevent the widening of these imbalances which became unsustainable under the effect of the crisis. The Commission pursued in vain countries in depression and not fulfilling the 3% of GDP limit for the government deficit (especially France and Germany in 2003-2006) without seeing that the danger was coming from countries with rapid growth, which were bringing their public finances in balance at the price of high increases in private or external indebtedness.

The 2007-2009 crisis was a banking and financial crisis, caused by hazardous innovations, in a context of uncontrolled financial globalisation and liberalisation, of rising amounts of capital looking for liquid and high returns. Financial markets were greedy, blind, and instable. Financial globalisation allowed for a rise in imbalances which finally burst (Mathieu and Sterdyniak, 2009).

The crisis is not due to the rise in government debts and deficits. In 2007, the euro area deficit was amounting 0.6% of GDP only. However the crisis generated an unprecedented deterioration of public finances, due to the need to rescue banks, to stabilise output, and even more because of lower tax revenues resulting from lower output. Public finance deterioration was smaller for the euro area as a whole, where the deficit reached 6.2% of GDP in 2010, against 8.3% in Japan, 10% in the UK and 12.2% in the US. From 2007 to 2013 the debt-to-GDP ratio rose by 27 percentage points in the euro area, by 40 percentage points in the US, 51 in the UK, and 60 in Japan.

The euro area was unable to implement a coherent strategy to recover the 10 percentage points of output lost because of the crisis. Even worse, financial markets bet on the failure and euro area exit of several MS. Three countries were placed under the Troika's supervision (Greece, Portugal, Ireland). Two other countries (Spain, Italy) suffered from excessively high interest rates. The financial crisis developed into a sovereign debt crisis in the euro area.

The EU authorities and the MS did not respond sufficiently rapidly and strongly. They denied to guarantee public debts; they implemented limited solidarity only, and under strict conditionality. Under the Commission's pressure, financial markets' and rating agencies' fears, MS had no choice but implement restrictive policies, which in times of austerity undermines their output growth and their social model.

At the euro area level, fiscal consolidation measures amounted to 1.7% of GDP in 2011, 2.0% in 2012 and 1.1% in 2013. Under the Troika's pressure, Southern MS implemented even more drastic fiscal plans. This strategy brought the nascent recovery to an end (at the end of 2010, euro area GDP was 2.2% higher than at the end of 2009). Euro area output declined the two following years. These fiscal contraction policies had a negative impact of around 8.0% of GDP for the euro area, but 16% for Spain and Portugal, 30% for Greece. Public debts-to-GDP ratios hardly declined due to the output fall.

In 2011-2013, global demand remained too weak in the euro area. Northern countries, with rooms for manoeuvre should have implemented expansionary policies to offset restrictive policies run in Southern countries. European investment programmes to help the industry to reorient current activities and develop innovative and green sectors should have been launched. Fiscal policy should not have been restrictive at the euro area level as long as the euro area economy was not moving sufficiently rapidly towards full-employment.

Can fiscal exit strategies ignore the causes of the crisis? The crisis is due to growth strategies based on downwards pressure on wages and social benefits. The fall in demand was offset by competitiveness gains in neo-mercantilist countries, by rising financial and real estate bubbles and households borrowing in Anglo-Saxon and Southern Europe countries. The failure of these two strategies has forced to use public deficits to support growth. Reducing public deficits requires the implementation of another growth strategy based on wages and social incomes distribution, on a new industrial policy geared towards an environmentally sustainable economy. Before the crisis, public finances also suffered from tax evasion and tax competition. Restoring public finances requires to combat tax evasion and tax havens, to raise taxes on multinational companies, on higher incomes and wealth.

2. Some federalism?

2.1. The fiscal Treaty

Even though the rise in deficits is a consequence and not the cause of the crisis, the Commission persists in saying that the crisis is due to fiscal indiscipline. The fiscal Treaty adopted on 2 March 2012 is supposed to eradicate this.

This Pact requests MS to bring their structural government deficit below 0.5% of GDP, according a time frame proposed by the

Commission. But this figure has no economic rationale. Estimating structural balances is more than problematic, especially in the event of strong macroeconomic shocks. The Commission's estimates will have to be used, but these estimates are always revised, are always close to observed output, since the Commission considers that falls in productivity growth and capital stock in recessions are structural: thus, the under-estimation of the cyclical part of the deficit will require to implement counter-cyclical policies.

The structural deficit target can be lowered to 1% if debt stands below 60% of GDP. A country with GDP growing by 1.75% per year and inflation rising by 1.75% per year sees in theory its debt coming down to 28.6% of GDP. But nothing guarantees that the macroeconomic equilibrium may be ensured with *a priori* set values.

According to article 5, a country under an EDP will have to submit its budget and its structural reform programmes for approval to the Commission and the Council who will also exert surveillance on their implementation. This article is a new weapon to impose liberal reforms to MS populations. According to article 7, the Commission's proposals will be automatically adopted unless there is a qualified majority against them, the country concerned not voting. Thus, in practice, the Commission will always have the last word.

The Pact forbids discretionary fiscal policies, although the latter are needed to reach a satisfactory macroeconomic stabilisation. According to the Treaty, each country should take fiscal *consolidation* measures without accounting for the cyclical conditions and policies in other countries. Despite the 2008-2013 experience, the Treaty maintains the implicit assumption according to which restrictive fiscal policies have no impact on output. No real economic policy coordination is considered, i.e. an economic strategy using monetary policy, fiscal, taxation, social and wage policies, to bring MS closer to full employment and to reduce imbalances between MS.

2.2. Improving economic policy coordination

In 2011 a first 'European semester' was introduced, during which MS present their fiscal plans and structural programmes to the Commission and the European Council, who both give their opinion before the vote in their national parliament in the second semester of the year. Such a process could be useful if the objective was to define an agreed economic strategy, but, in fact, this semester increases the pressure on each MS to implement austerity measures and liberal reforms. No agreed plans to reduce imbalances between MS or to support growth have been implemented in 2012, 2013 or 2014.

The Six-Pack allow the Commission to exert surveillance on the excessive macroeconomic imbalances in each country by following a scoreboard of relevant variables (competitiveness, external current account, public and private debts). A Macroeconomic Imbalance Procedure (MIP) has been introduced. So far the Commission does not recommend coordinated strategies to support growth or to reduce imbalances, but only signals each country what their problems are.

2.3. Some very conditional financial solidarity

The European Stability mechanism (ESM) launched in October 2012 introduces some degree of financial solidarity between the MS, but this solidarity is limited and has a very high price. Countries may benefit from the ESM if they have adopted the Fiscal pact and have fulfilled it. The ESM support will be conditional: a country needs to commit to fulfil a drastic fiscal adjustment programme imposed by the Troika, and will therefore lose all domestic fiscal autonomy and have to accept a long austerity period. The Greek example shows that this type of plan is not the way out of the crisis. The solidarity which is being implemented does not consist in donations but in loans. The ESM debt will be considered prior to private ones. Public bond issuance should involve a collective action clause, i.e. in case of default, stated by the Commission and the IMF, the country will be entitled to agree with creditors on a change in payment conditions, the agreement applying to all creditors if a majority agrees. Euro area government debts will become speculative as was the case for developing economies; the interest rate on public bonds will rise, be more volatile and less easy to control. Why build the euro area to reach such a situation?

On 6 September 2012, the ECB announced a purchasing bonds programme on the secondary markets, for short-term bonds (1-3 years), the so-called OMT (outright monetary transactions). In putting no ceiling to its interventions, the ECB reassured markets on default risks in the concerned countries, on the risks of a euro area break-up. The ECB broke the spiral of self-fulfilling expectations and finally did not have to intervene. Lower interest rates can help to boost activity. Conversely, the ECB imposes its views on the economic strategy to be implemented, requests product and labour markets structural reforms, the full commitment to government balance targets despite the recession. Although the OMT was not used in practice, the simple fact that it exists was sufficient to reduce substantially interest rates spreads. In February 2014, the Karlsruhe Constitutional Court refereed the case of the OMT before the Court of Justice of the European Union, judging that it was not conform to the German constitution, which could oblige Germany to finance spending not being voted by the German Parliament. The euro area remains under the threat of financial markets defiance, following elections results or the appearance of economic, fiscal or banking imbalances. This is a house of cards rather than a solid edifice.

2.4. Towards a deep and genuine economic and monetary union?

In November 2012, the Commission suggested major steps towards federalism (European Commission, 2012):

— 'All major economic and fiscal policy choices by a MS should be subject to deeper coordination, endorsement and surveillance process at the EU level'. The possibility of different economic or social strategies is forgotten or prohibited.

— The needs for strengthened fiscal discipline and for *ex ante* fiscal coordination are asserted. But, after the fiscal pact, what remains to be coordinated since all fiscal policies have to be run in autopilot mode?

— The EMU could be entitled to use a "convergence and competitiveness instrument", within the balanced budget framework. A country could sign an agreement with the Commission, according to which it would implement structural reforms and would therefore get a financial reward from other MS. Can we imagine that a country would get subsidies in order to abolish its minimum wage, or its public pensions system?

— A common European Redemption Fund (ERF) could be introduced to amortise public debts, with strict conditionality, based on the German proposal (see Doluca *et al.*, 2012): each country would have to commit to reimburse each year a share of the public debt above 60% of GDP, so as to bring public debt below 60% of GDP in 25 years. In counterpart of this commitment, the share of the debt above 60% of GDP would be commonly guaranteed. But this project requires to implement even more fiscal contraction, and does not consider the impacts on output, debt, and deficits. It assumes that fiscal policy may be run in an automatic mode, and be entirely devoted to the debt reducing objective.

— The proposal to issue euro-bonds guaranteed by all MS or by the ECB has not been considered. Germany refuses to make unlimited and unconditional commitments to support other MS. But how to strengthen the euro area without such commitments?

Three questions remain:

1. Should EU institutions' powers be strengthened, as long as there is no guarantee that EU institutions could work more democratically, as long as the EU does not implement a growth strategy, as long as it remains focused on absurd public finance criteria, liberal structural reforms, and public expenditure cuts?
2. Can we imagine all major economic and social decisions being made at the EU level, by the Commission or the Council without accounting for national votes and debates?
3. Can we image a federal power able to account for domestic specificities in a Europe made of heterogeneous countries? Can we imagine a single policy implemented in different countries? Or different policies implemented through a central process?

Some consider that the euro area could introduce short-term stabilisation mechanisms managed by the European Commission (European Commission, 2013), but this is an illusion with the Commission underestimating output gaps and forbidding discretionary policies. Some suggest the unification of unemployment insurance systems, but national systems are often managed by social partners and are currently very diverse. The unification of the systems would be likely to be made towards the bottom. A country having made efforts to reduce its unemployment rate will refuse to pay for high unemployment rates countries, and will blame the latter for not having undertaken the necessary reforms. Some (like Enderlein *et al.*, 2013) propose to base transfers between MS on output gap differentials, but they forget that output gaps are a vague concept, with a questionable and variable over time measurement. MS do not need fiscal federalism, but they need to recover the ability to run stabilisation fiscal policies.

Requesting that each country reaches a macroeconomic equilibrium with budgetary positions in balance implies that private sector savings have a counterpart in an external surplus (the German model). This requires that the rest of the world agrees to absorb European surpluses, and also that Southern MS increase their competitiveness. This implies a long stagnation period followed by an investment rebound. This scenario is unlikely if wage cuts depress output so much that profits do not improve, and investment remains depressed due to weak domestic demand. Austerity policies are more likely to depress permanently economic and social dynamism in those countries.

3. A new economic policy framework?

The euro area needs to choose between two frameworks: relying on markets to implement fiscal discipline or introducing measures to re-establish the unity of public debts. The first option has several drawbacks: maintaining interest rates spreads in Europe for an undefined time period, undermining the impact of fiscal policies and letting financial markets play an excessive role. The second option requires an issue to be settled first: according to which criteria and up to which level can a MS public debt be guaranteed by its partners? Several projects have not entirely made a choice between the two frameworks (see Gros and Mayer, 2010, Palley, 2011, De Grauwe, 2012, Schulmeister, 2013).

The simplest solution would consist in introducing a European debt agency (EDA), in charge of issuing a common debt for all euro area countries. This debt would be considered as safe by financial markets; it would be very liquid and could be issued at very low interest rates. But the EDA council would supervise domestic fiscal policies and would be entitled to deny financing *too lax* countries, which would then have to issue bonds on markets. The EDA would strengthen the Stability Pact problems. What would be its assessment criteria? What would be the democratic and economic legitimacy of its Council? How would the EDA decide that a country runs an excessive deficit, if the country considers that such a deficit is necessary to support activity (like in Germany and France in 2002-2005) or to rescue banks? Would it implement rigid rules (a country would be entitled to loans from the EDA up to 60% of its GDP) or softer ones? The EDA would benefit neither virtuous countries (which have no difficulty to get financing) nor countries in difficulty, which the EDA would refuse to finance and which would have to sue domestic bonds, without any European guarantee, without any potential financing from the ECB, in other words risky assets, bearing a high interest rate. These countries would be dependent on financial markets. The EDA makes sense only if it can finance all public debts, but then what should be done against lax countries?

Delpla and von Weisäcker (2010) have suggested the introduction of a 'blue debt, collectively issued and guaranteed, with a ceiling at 60% of GDP'. Each MS would also be allowed to issue a red debt under its own responsibility, and hence at a high interest rate. This would be a strong disincentive to issue public debt above 60% of GDP. This proposal is almost similar to the EDA proposal and raises the same problems. The 60% level is arbitrary, and account neither for economic stabilisation needs, nor for the desire from financial institutions to own government debt. The 60% level is currently breached by 10 of the 12 original euro area MS (except Luxembourg and Finland). The gap between blue and red debts would allow financial markets to speculate in permanence.

3.1. The single currency's contradictions

The system which worked until 1999 lied on unity between the government, the central bank and commercial banks. The central bank is the lender of last resort for the government and banks. The government can issue unlimited public debt. This debt is considered as safe and hence benefits from as low as possible market interest rates. Of course this unity was undermined by the central bank independence, which could have generated conflicts between the government (caring about supporting output or specific spending) and the central bank (caring about maintaining low inflation). These conflicts could have led public finances to become unsustainable (see, for instance, Sterdyniak *et al.,* 1994). But such situations did not occur before 2007. They did never question government solvency.

The introduction of the euro area led to a particularly difficult situation. On the one hand, countries need to run more active fiscal policies because they have lost control over their interest rates and exchange rates. It can also be added that, since 1973, the macroeconomic equilibrium has been requiring a certain level of public deficit and debt. Each country needs to run some equilibrium government deficits. The 2007 crisis strengthened this need. On the other hand, due to the single currency, current imbalances in one country affect the other countries of the area: excessive deficits (and surpluses) should be avoided. But how should they be defined? Last, the financial markets' weight makes it necessary for public debts to become safe assets again, while at the same time Northern countries deny to give unlimited guarantee to their partners.

Therefore the procedures implemented since 2010 should be reviewed and their aims should be modified, which implies institutional changes. Euro area countries should be able again to issue safe sovereign debt, at an interest rate controlled by the ECB. They should be able to run a public deficit in line with their macroeconomic stabilisation needs. Public debt mutual guarantee must be entire for countries accepting to submit their economic policies to a coordination process.

A coordination process needs to be organised between MS. Coordination should target GDP growth and full employment; it should account for all economic variables; countries should follow an economic policy strategy allowing to meet the inflation target (at least to remain within a target of around 2%), to meet an objective in terms of wage developments (in the medium-run real wages should grow in line with labour productivity), in the short-run adjustment processes should be implemented by countries where wages have risen too rapidly or too slowly; increases or cuts in social contributions may be used to facilitate the adjustment process; countries should announce and negotiate their current account balance targets; countries with high external surpluses targets should agree to lower them or to finance industrial projects in Southern economies. The process should reach a unanimous agreement on a coordinated but differentiated strategy. Public deficits resulting from this process should be financed through debt issuance guaranteed by all euro area countries and by the ECB. The Treaty needs to maintain an effective process in the event where no agreement is reached. In that case, the new debt issued by countries outside the agreement would not be guaranteed, but such a case should never occur.

The EMS rules should be reviewed, the EMS should fully guarantee MS public debts, except in the case where MS depart from the commonly agreed policy. The EMS should have unlimited access to ECB refinancing.

In this context, the ECB could assign itself the objective of maintaining long-term interest rates at low levels, below euro area GDP growth. The euro area needs to recover the 10 percentage points of GDP lost because of the crisis. This would lead euro area MS public deficits and debts to be sustainable. Abandoning this objective means accepting mass unemployment in Europe. The EU institutions should elaborate a consistent exit crisis scenario, based on demand recovery, on households' consumption and public spending, on investments for the future, within the environmental transition process, and on coordinated decreases in today's imbalances.

Euro area's survival requires that the European project becomes popular again, therefore is a source of growth, social progress and solidarity. It is only within this framework that institutional progresses could be made.

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