Session 6: Economic Governance in the Monetary Union

The shape of economic governance

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The recent crisis clearly demonstrates that European integration has reached a dangerous intermediate position between a purely national policy making and a truly coordinated and cooperative approach for the management of a monetary union. It is not a very difficult forecast that this intermediate position is not a stable equilibrium, but that it will either progress to a common economic governance or regress to a fiscal and monetary nationalism that would destroy the progress in field of economic and political European integration of several decades.

For a discussion of the shape of enhanced economic governance, or the possible content of an economic government, it seems useful first to discuss the main areas where more coordination and cooperation is needed and then to ask the question which institutions could be made responsible for these functions. In my view there four areas where much stronger governance at the euro area level is required:

- The euro area lacks a comprehensive fiscal policy. There is no institution that feels responsible for the determination of the necessary size of the aggregate fiscal balance, nor is there any assignment of a required fiscal policy stance to individual member countries.
- The euro area lacks an efficient surveillance of private sector financial balances in individual member countries with an aim of preventing national boom and bust cycles.
- The euro area lacks a monitoring of wage developments at the national level which could help to prevent the emergence of longer-term divergences in unit labor costs and competiveness which are difficult to correct ex post.
- As the Stability Growth Pact has not been able to prevent the fiscal disaster of Greece, this framework needs a more credible commitments and more efficient sanction mechanisms.

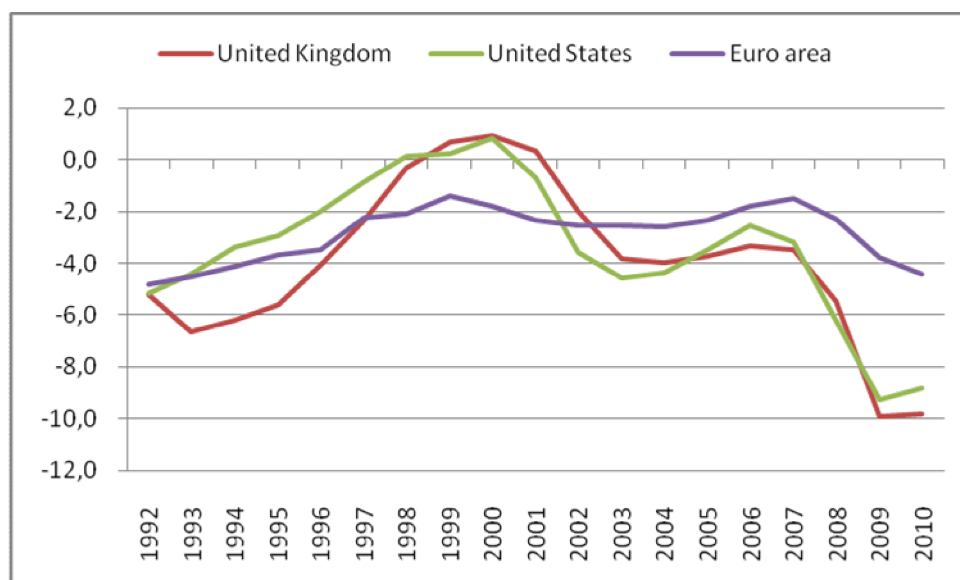
The lack of common fiscal policy

A major difference between the euro area and the United States is the lack of a common fiscal policy. In other words, while the fiscal policy stance of the United States is the result of a deliberate political decision, in the euro area it is the accidental outcome of the decisions of 16 individual member countries which are mainly guided by national deliberations. This deficiency was detected already in 1989 by the Delors report:

„(…) the fact that the centrally managed Community budget is likely to remain a very small part of total public-sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the coordination of national budgetary policies. Without such coordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance…Monetary policy alone cannot be expected to perform these functions. „

Unfortunately this early insight of the Delors Commission it has never received sufficient attention by the relevant bodies of the European Union. Due to the complete absence of a framework for fiscal policy coordination, the fiscal policy response of the euro area to recession has so far been always been much weaker and over cycle less pronounced than in the United States or the United Kingdom. In addition, as the current crisis shows, the lack of a clear assignment of the obligations of individual countries offers a leeway for free-riding in fiscal policy, which also has the effect that the overall policy stance is too weak (Chart 1). The free-riders in the current recession are Italy, Belgium and Austria.

Chart 1: Structural deficits of the Euro area, United States and United Kingdom



Source: OECD. Value for the Euro area in 1995 own adjustment.

What can be done to overcome these problems. In principle the Treaty (Article 121) already requires member countries to coordinate their policies:

"Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120."

The Treaty even envisages sanctions ("warning") according to Article 121, 4.[1] Thus, no new institutions are required for such a coordination exercise it would be sufficient for the Commission and the Council to fully fill out the role that the Treaty has assigned to them. The main task of such coordination would be the definition of a target value for the aggregate fiscal policy stance over the medium term. This would be especially needed in the current situation with a high risk that an uncoordinated fiscal policy consolidation will lead to an over-consolidation for the euro area that could repeat the double-dip scenario that took place in the United States in 1937.

Surveillance of private sector financial imbalances

[1] Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned. The Council, on a recommendation from the Commission, may address the necessary recommendations to the Member State concerned. The Council may, on a proposal from the Commission, decide to make its recommendations public.

The second area where more coordination is needed are private sector financial (im)balances. If one goes back to spring 2007 Spain and Ireland were regarded as show-pieces of fiscal stability. If these two countries are now trapped in severe fiscal distress it is due to the huge private financial imbalances that accrued in the pre-crisis years. As the implosion of the housing bubble forced the governments to bail-out the financial sector and to support a huge amount of unemployed workers, the private imbalances have been transformed into public financial imbalances.

Thus, a reform of the SGP would not be able to prevent similar processes. What is required instead is an efficient supervision of private sector imbalances which could act as an early warning system. Which institution should be in charge of this task? In my view the ECB with its impressive macroeconomic expertise is a natural candidate for this role. However, in the past the ECB understood its responsibility only with regard to the euro area average. Thus, in the years 2006 and 2007 it always argued that the euro area had a balanced current account, fully disregarding the fact of the huge national discrepancies behind this surface.

The new role of the ECB could be established by assigning to it the objective financial stability in addition to the objective of price stability. This would automatically make the ECB feel responsible for national financial balances.

With which instruments could the ECB try to prevent major private sector financial imbalances? In my view the ECB or the European Systemic Risk Board could impose country specific capital surcharges for bank lending if an overheating a certain economy has been identified.

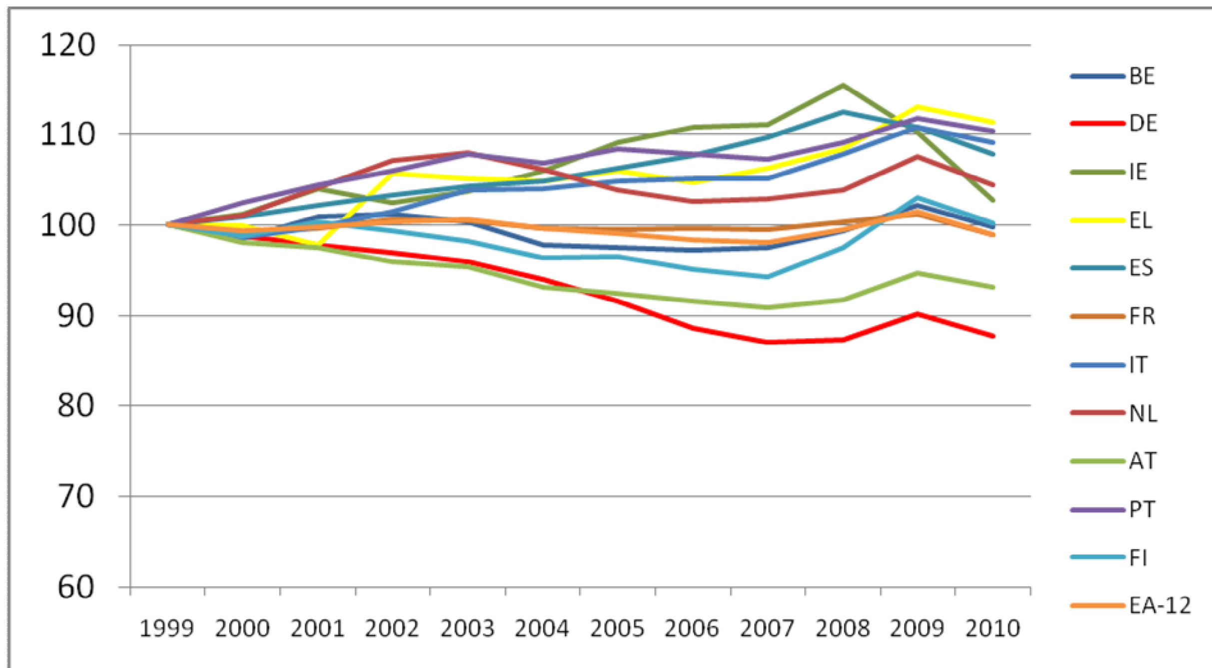
Wage monitoring

The most serious problem that the euro area is currently facing is the divergence of unit labor costs which has developed over the last decade. As it amounts to 15 to 20 percentage points between Germany on the one hand and Spain, Italy, Greece and Ireland on the other it is very difficult to equalize. Given the fact that German trade unions are very much focused on safeguarding employment instead of asking for higher wages, wage increases in Germany will remain very limited in the next few years. Thus, the other euro area countries can only restore their competiveness by drastically reducing their wages which has a high risk of initializing a deflationary process for the whole euro area.

In order to prevent such divergences in unit labor costs for the future a regular wage and competitiveness monitoring by the Commission is required. In contrast to the present procedure in the "Surveillance of Intra-Euro-Area Competitiveness and Imbalances" it should become symmetrical and use numerical benchmarks. This could be derived by adding up national productivity increases and the target value of the ECB for price stability. On this basis it would have been possible in 2005/06 at the very latest to identify a "wage dumping" in Germany as well as excessive wage increases in Southern Europe and Ireland (Chart 2)

Of course, wages cannot be determined by the government or the European Commission. But the Commission could exert a strong influence on the national wage-setting process by announcing indicative wage orientations if it comes to the result that their a serious divergences in wage developments and competiveness.

Chart 2: Deviation of unit labor costs from a benchmark defined by an increase in productivity and the ECB's inflation target of 1.9 %



Source: European Economy, own calculations

Improving the SGP

For better economic governance in the euro area it is also important to improve the SGP. In retrospect one of the major flaws of the SGP is a lack of memory. Thus, even after years of excessive deficits Greece could escape the sanctions of the corrective arm in April 2007 simply as it was able to demonstrate that for the current and consecutive year it would be able to achieve a deficit of less than 3 %. Introducing a memory in the SGP would imply that countries that failed to keep their deficit below the 3 % target in good times would be obliged to keep it under this target in order to compensate for the previous excesses (Table). This would have obliged Greece to pursue a much more stringent fiscal policy. The proposals to orient the excessive deficit procedures to the debt to GDP ratio would have a similar effect, but the introduction of a memory does not require the definition of a target value for the debt to GDP ratio.

Table 2: The revision of Greek data between the figures reported in EDP March 2004 and April 2007							
% of GDP	2000	2001	2002	2003	2004	2005	2006
General Government Deficit							
2004 March	-2.0	-1.4	-1.4	-1.7			
2004 September	-4.1	-3.7	-3.7	-4.6			
2005 March		-3.6	-4.1	-5.2	-6.1		
2005 September		-6.1	-4.9	-5.7	-6.6		
2006 April			-4.9	-5.8	-6.9	-4.5	
2006 October			-5.2	-6.1	-7.8	-5.2	
2007 April				-6.2	-7.9	-5.5	-2.6
General Government gross debt							
2004 March	106.1	106.6	104.6	102.6			
2004 September	114.0	114.7	112.5	109.9			
2005 March		114.8	112.2	109.3	110.5		
2005 September		114.4	111.6	108.8	109.3		
2006 April			110.7	107.8	108.5	107.5	
2006 October			110.7	107.8	108.5	107.5	
2007 April				107.8	108.5	107.5	104.6

Source: Recommendation for a COUNCIL DECISION abrogating Decision 2004/917/EC on the existence of an excessive deficit in Greece (presented by the Commission)

A second necessary improvement of the SGP concerns its sanction mechanism. The disadvantage of the sanctions in the present SGP is that they increase the deficit problems instead of reducing them. What is required is a mechanism that makes it possible that the Union can force countries to raise a temporary surcharge on the income or value added tax if there is an excessive deficit and if a country has been unable to reduce it by itself. Of course it will not easy to implement such a mechanism as it interferes with national responsibilities and constitutions. But it seems worth the effort to find the necessary legal constructs as all other sanctions (fines, temporary suspension of voting rights) seem relatively inefficient.

Finally, the SGP is too much focused on deficit levels, although this is an aggregate that can only partially controlled by the government. This also applies to structural deficits which are very much influenced by the most recent data points. Therefore, it would be advisable to formulate the commitments in terms of a rule for government expenditures (excluding unemployment payments) which can be controlled very well by the government and which allow a timely surveillance by the Commission and also the wider public.