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Multilateral Surveillance

NOTE

Abstract

The financial crisis first, the public debt crisis next have exposed some serious flaws in European governance. In order to deal with these flaws, it is essential to dig deep enough to reach a proper diagnosis. Fixing the Stability and Growth Pact by making it "tougher" will not work because of the contradiction between the Pact and national sovereignty in budgetary matters. Similarly, enhancing mutual surveillance is either useless because procedures are already in place, or will be ineffective until European-level instruments are put in place.

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Executive Summary

1. The European public debt crisis has exposed some flaws in the EU, particularly damaging to the euro area. One line of thought is that this calls for better governance. The problem with this view is that the issues that merit collective European-level interventions are defined as part of national sovereignty. Better governance, therefore, would require new transfers of competence, which means a revision of the Treaties. Sidestepping this question is bound to produce disappointing results and to further dim popular support for "a European Union that does not deliver on its promises".

2. This is clearly the case of the Stability and Growth Pact (SGP). Budgetary discipline is clearly a matter of common concern, but fiscal policies are set by sovereign governments and parliaments. Strengthening the SGP, as is currently being discussed, will not improve matters unless a Treaty revision provide for the necessary instruments. In addition, the economic logic of the SGP is seriously flawed and the politics of sanctions implies that the Pact cannot be credible.

In order to achieve budgetary discipline, a wholly different approach must be adopted. It must recognize that, as matters stand, discipline can only be ground out at the national level. This calls for legal, possibly constitutional, changes of the way national authorities prepare and execute their fiscal policies. Also needed is a redefinition of fiscal discipline, away from annual budget balances and toward long-run debt level reduction.

3. The EU2020 approach is destined to face the same fate as the Lisbon Strategy, for the same reason: the required instruments are only available at national level.

4. Before engaging of mutual surveillance of external imbalances, we need to understand why these imbalances occur. Over the 2000s, they were either the outcome of undisciplined fiscal policies in some countries that ran external deficits, or the consequence of divergences in saving patterns. As it turns out, too low saving in the external deficit countries reflected excessive bank credit growth. Monitoring credit growth is indeed desirable, at least within the euro area. This is precisely why the European Systemic Risk Board (ESRB) is being established. What the Board will lack is authority over national supervising authorities. The new arrangements under discussion fall short of what would be desirable to establish adequate governance in this crucial area. This is where ambitions should be concentrated at this juncture.

1. From wishful thinking to clarity of objectives

The draft European Parliament own initiative report (INI) on "Improving the economic governance and stability framework of the Union, in particular in the euro area", also known as the Feio report[1], starts with an important and accurate observation:

"The current economic, financial and social crisis has shown that the existing economic governance model in the Union has not worked as effectively as it was ideally envisaged. During the past years enough convergence between Member States has not occurred. In stead macro-economic and fiscal imbalances have remained and even become larger during last 11 years."

A key challenge is to interpret the reasons behind the failure of governance and, then, to draw policy recommendations that have a better chance of success than the existing, failed framework.

Art. 121 stands in complete contradiction with the subsidiarity principle as stated in Art. 5. The same applies to the Stability and Growth Pact (SGP) and to the EU2020 objectives that aim at replacing the previously failed Lisbon Strategy. Fiscal policy may be a matter of common concern, as the Greek debt crisis clearly illustrated, yet it remains clearly under national jurisdiction. Growth-enhancing policies covered by the EU2020 objectives stand to benefit all member countries, yet they mostly belong to the national level of decision.

The tension is understandable. Fiscal indiscipline in a member country is the outcome of unsatisfactory national political processes. Other member countries rightly observe that fiscal discipline creates serious risks for the whole euro area and, therefore, for the whole Union. The SGP is a natural response, if it can be made to work. Similarly, poor institutions that hamper growth in a member country have a detrimental effect on the Union as a whole. Since economic reforms are always politically difficult, it makes sense to seek to counteract national private interest groups with peer pressure. The experience shows that none of these two approaches have worked. The temptation is to try again, and harder. This is bound to fail for a fundamental reason: national polities will not give in to European-level pressure if it runs against their own interests. This is why the contradiction between Articles 5 and 121 will always lead to outcomes where national sovereignty prevails over common interests, no matter how justified the latter are.

The situation may be depressing. One could easily envision a better world where important externalities – the fact that one country's action affects other countries – would be recognized as *force majeure* cases for limiting national sovereignty. This has been the universal evolution of federal states, where one externality after another has prompted transfers of power to the federal level. In the EU, any such step requires a new treaty. Believing that the current balance of power in areas relevant to the SGP and the EU2020 objectives can be modified without a new treaty is wishful thinking. Decisions can be made, adding to existing contradictions, but they will not be operational. The SGP and the Lisbon Strategy have become large-scale machineries that create the impression that "things are being done" but nothing is achieved whenever national preferences are challenged. The Commission has invested considerable resources into these undertakings but, despite its best efforts, it has little to account for the effort. The Commission claims that the fiscal

[1] Named after its Rapporteur, Diogo Feio. Avalaible on EP Legislative Observatory under: http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=2&procnum=INI/2010/2099.

situation would have been worse absent the SGP. This unverifiable assertion may well be correct, but as noted above, that was not enough to avoid the public debt crisis – which is far from over. Similarly, the Lisbon Strategy failed to stem growing divergences within the euro area. More of the same will only deliver disappointment some years down the road.

The EU cannot, once again, disappoint. While dire forecasts of an impending explosion of the euro area have proven, so far at least, illusory, "Europe" does not carry as favourable image among its citizens as it used to when ambitions were lower. What is seen by actors and observers at the centre as national government failures to live up to their commitments, is often perceived by citizens as one more EU failure. For this reason, among others, Treaty changes that strengthen the centre are unlikely to pass in the coming years. The challenge is to put back the EU in working order within why is possible the current Treaties and to do so effectively. This means that the following considerations must prevail when making governance changes:

1. No measure should seek to exploit the contradiction between Art. 121 and Art. 5.

2. Any measure that aims at fulfilling Art. 121's laudable objectives must make full use of national sovereignty.

3. Any measure that aims at transferring de facto authority from the national to the European level must be framed within a Treaty revision.

2. Fiscal discipline

2.1 Getting the diagnosis right

The draft Feio report of the European Parliament correctly observes that "the surveillance framework was too weak and the rules of the Stability and Growth Pact were not sufficiently respected, in particular as regards the preventive arm." This is undoubtedly true and it applies to the corrective arm as well since the Pact has been suspended every time it was meant to be binding. The diagnosis is more complex than meets the eye, however. The SGP, in both incarnations (before and after the 2005 revision), suffered from several fatal flows:

The conflict with national sovereignty, noted above, implies that governments do not abide by the SGP obligations when doing so would carry serious domestic political and/or economic costs, i.e. when the Pact is meant to bite.

The SGP has been implemented by focusing on annual deficits, which are only partially under the control of the national authorities. Slow growth and recessions lead to larger than honestly expected deficits and the time to correct the slippage is almost never when this happens. It takes a long string of annual deficits to create a dangerous situation, as the Greek example illustrates.

This is why the 2005 revision has tried to shift the focus to structural deficits, which take into account the cyclical situation of each country. It remains that even structural deficits have limited significance in terms of fiscal discipline. While permanent deficits constitute a breach of discipline, there may be good reasons to run deficits over several years. This is

the case when these deficits are used to finance productive spending, like public investment or deep economic reforms. The Commission now explicitly recognizes this point, but it implies a value judgment that is bound to be controversial. Using a controversial viewpoint to impinge on national sovereignty is politically impossible.

There is now belated recognition that the only appropriate gauge of fiscal discipline is the long-term evolution of the public debt. Implementing this criterion at the EU level, however, is particularly difficult. The 60% reference is dramatically outdated and therefore cannot be used as a guide. In fact, there is no "good" level for a public debt, this is why the proper criterion is the debt's long-term evolution. But this too involves a value judgment, which takes us into controversial territory.

Enforcement issues illustrate the contradiction between the SGP and national sovereignty. The contradiction means that it may be impossible to force a government to abide by the SGP obligations. The natural response to foreseen delinquency is punishment. Punishing a country, however, is what Eichengreen and I called in 1997 the "nuclear deterrence option".[2] Punishing a democratically-elected and friendly government, which may enjoy popular support for the policies that lead to deficits, is historically unheard of and could generate massive rejection by the citizens. This is why, like a nuclear weapon, it is a weapon to be brandished but not used. Once it is not used, as in 2003 and 2009-10, it loses its deterrence power. Making the sanction even tougher, as is currently envisioned, is meant to restore deterrence power. This is illusory for it only raises the stakes – the size of the nuclear weapon – and therefore makes the use of the weapon even less likely. Enforcement of the SGP is simply impossible, which means that the Pact is not credible.

That the SGP was not respected and not properly enforced is correct, but that does not amount to a diagnosis. The reasons why this happened must be recognized. Once its flaws are identified, it is pretty clear that making it "harder" will not help with enforcement. Widening the range of criteria (structural deficit, debt level, general orientation of fiscal policies) makes good economic sense but unavoidably injects the need to pass judgement on questions that are deeply controversial and cannot, therefore, be subsumed by a simple indicator. Attempts at improving the SGP will require difficult negotiations and its implementation will continue to be plagued by deep disagreements. As feared more than a decade ago, the SGP represents a major diversion, mobilizing policymakers away from core issues.

2.2 Resolution of the contradiction

The SGP is the wrong answer to the right question: how to ensure that no euro area member country becomes a source of collective instability as a result of fiscal indiscipline? The right answer must recognize that fiscal discipline is a national responsibility because the relevant instruments, spending and taxation decisions, belong exclusively to national governments and their parliaments. The answer must therefore bind national authorities through national constraints. Because fiscal discipline is a matter of collective interest, these constraints must be agreeable to all other member countries and guarantees must be given that the constraints will be adequately enforced.

[2] Barry Eichengreen and Charles Wyplosz, "The Stability Pact: Minor Nuisance, Major Diversion?", *Economic Policy* 26, October 1997.

A number of countries, in the EU (Belgium, Germany, Hungary, the Netherlands, Sweden, the U.K.) and elsewhere (Brazil, Chile, India, New Zealand, Switzerland) have adopted various procedures designed to deliver fiscal discipline. These procedures include budget balance rules, ceilings on public spending and the setting up of independent fiscal committees. Since many of these procedures have been adopted recently, evidence of their effectiveness has yet to be established, but older arrangements have undeniably played a significant role in achieving fiscal discipline. Importantly, these procedures follow recognition at the national level that democratic systems have a natural tendency to deliver fiscal indiscipline as numerous interest groups encourage public spending while other groups oppose taxation. Put differently, it is in the national interest of individual EU countries to strengthen their budgetary processes.

It follows that, as far fiscal discipline is concerned, individual and collective EU interests coincide. Why, then, is the adoption of adequate procedures not occurring spontaneously? The reason is that interest groups are well organized at the national level and often successfully manage to prevent the adoption of procedures that would effectively reduce their bargaining power. Outside prodding stands to tilt the balance of pressure and counter-pressure that leaves many countries in a situation where enforcement of fiscal discipline is chronically undermined. One-off outside pressure is sometimes applied by the IMF in times of acute instability, but the effect is usually short-lived because it is not institutionalized. The current situation, which combines large deficits and exploding debts with the need to rethink governance, opens a window of opportunity for the EU to encourage the adoption of national institutions.

The solution, therefore, is to supplement the SGP with a request that every euro area member country adopt adequate institutions.[3] There is no single model that can be identified as the best one. Because national traditions and procedures differ significantly from one country to another, the choice of the solution can be left to each member country. For instance, the Netherlands has a long tradition of effective but soft control by the Central Planning Bureau, Germany has recently established a constitutional rule and Hungary and the U.K. have even more recently set up independent fiscal committees, following on the footsteps of Sweden. The advantage of what can be seen as a decentralization of the SGP is that the control is exercised at the national level, where authority lies. Art. 5 is perfectly compatible with fiscal discipline. How about Art. 121?

The question is how countries can be compelled to adopt adequate procedures. A first answer is that they cannot. In the absence of a new treaty, sovereignty precludes any obligation. A second answer is that national and collective interests coincide so that collective pressure may help governments to overcome the resistance of interest groups. Finally, it would seem natural to use the recently created European Financial Stability Fund (EFSF) as a lever: only those countries that adopt validated procedures will be eligible to EFSF support. Every country may refuse the condition, but it would forego the collective insurance system, which would raise suspicion on the financial markets, undoubtedly a convincing mean of conviction.

[3] What follows is a brief summary of the proposal developed in my June 2010 Note to the Economic and Monetary Affairs of the European Parliament.

3. Imbalances

The Greek crisis has also brought to the fore the fact that current accounts have tended to diverge within the monetary union. As a result, policymakers have started to discuss how to monitor the situation, with a view to avoid such divergences in the future. Here again a diagnosis should precede policy proposals.

3.1 Diagnosis

It has been widely noticed that the countries which have exhibited rising current account deficits (Greece, Italy, Spain, Portugal) also saw their production costs rise relative to their competitors. The problem is not low productivity gains, but wages and prices that grow faster than justified by productivity gains. This implies that lack of productivity, the core of the Lisbon Strategy and of the EU2020 objectives, is not an issue here.

Higher inflation, then, is identified as the cause of the deficits. The problem with this interpretation is that inflation is usually caused by monetary policy and that there is no national monetary policy within the euro area. What, then, can have caused the rise in production costs? Three main possibilities exist:

Catching up. It is normal for relatively poorer countries to exhibit higher inflation as they catch up with the more advanced countries. This effect, called the Balassa-Samuelson effect, occurs when productivity rises faster.

Initial conditions. In countries that join the euro area with higher inflation, the real interest rate is lower, which feeds domestic demand and exerts upward pressure on prices and wages. This effect, called the Walters effect, is a known by-product of any monetary union.

Budget deficits. With fiscal policies decided at the local level, it is possible for a country to support domestic demand with an expansionary stance. Strong demand, in turn, leads to higher inflation.

The first interpretation can be ruled out on two grounds: catch-up inflation does not raise production costs and does not lead to external deficits. The question, then, is whether the growing external imbalances have been caused by increases in private spending or by deteriorating budget balances. The following figure, which decomposes the current account balance in two components, net private sector and the budget balance, provides the answer.[4] In the three countries where the current account surplus has increased or just remained strongly positive – Austria, Germany and the Netherlands – the driving force has been the high level of private saving. In two of the four countries where the current account has been negative – Greece and Portugal – both low private saving and large budget deficits are involved, while Spain where the budget position has improved in Spain until 2007 underwent a decline on net private saving and Italy’s external deficit was mostly fed by the public deficit.

The conclusion is that rising prices are not a cause but a symptom of the growing external imbalance problem. The first cause is private saving divergence, the second is public budget deficits.

[4] The accounting identity is: current account = net private saving + budget balance. Excluded from the figure are France, where the current account has been about balanced, Luxembourg which is a special case, and the more recent euro area members (Cyprus, Malta, Slovakia and Slovenia).

3.2 Surveillance: what for?

An implication is that the mutual surveillance process under study will have to focus on public budget balances and private saving. Regarding fiscal discipline, the SGP already involves timely careful surveillance of budget plans and outcomes, so no more is needed on that front. What could be added is surveillance of saving trends throughout the euro area, to detect the kind of growing imbalances that have emerged throughout the 2000s. These imbalances did not go unnoticed[5] but the question is: what to do about them?

It is important to note at the outset that there is no reason why private saving should follow the same pattern across the euro area. Making the case that saving is too low, or that borrowing is too strong, requires much careful analysis. Much the same applies to statements about too strong saving and too little consumption.

Throughout the 2000s, declining private saving in the external deficit countries, we now know, was fuelled by excessively rapid bank credit growth. This evolution would have been captured had the euro area been equipped with a macro-prudential agency. Such an agency is now under discussion. The planned European Systemic Risk Board (ESRB) will be responsible for detecting this kind of imbalances and, hopefully, from proposing policy measures when needed. The structure of the ESRB, its remit and authority may not be fully adequate, but the perceived need for mutual surveillance in this area will be met.

What remains to be done, is to translate surveillance into timely policy actions. Much as for the public deficits, however, bank credit oversight is not a shared prerogative. The de la Rosière Report has sought to strengthen Europe's role in the matter. It stopped short of proposing a European-level authority, obviously because this would require a treaty revision. Its relatively modest proposal has now been further watered down in the recently announced "compromise". If any effort at better governance is needed, this is where it is most needed, and urgently so.

3.3 When are external deficits a problem?

Contrary to a widely shared view, the euro area's current account imbalances need not be a concern. First because, as argued above, they are a symptom of other developments – public deficits, excessive bank credit growth – which can be easily observed and which can and should be solved at the national level.

A deeper reason for not elevating external imbalances to the status of collective concern is that, in and by themselves, they do not represent a threat. A country that runs external deficits in effect borrows from the rest of the world. Private external borrowing is subject to private monitoring. It cannot continue indefinitely. Sooner or later, private lenders will realize that private external debts become excessive and they will cut lending and ask for repayment. Fundamentally, this phenomenon is stable. The problem is that banks and markets often react too late and too strongly. This is the sudden stop phenomenon, which reveals dysfunctions in the international financial system. The Basel Committee and the Financial Stability Board have made consistent and coherent proposals to deal with these dysfunctions. Regrettably, adoption of these proposals is lagging, especially in the EU.

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[5] See Francesco Paolo Mongelli and Charles Wyplosz, "The Euro at Ten: Unfulfilled Threats and Unexpected Challenges" in: Bartosz Mackowiak, Francesco Paolo Mongelli, Gilles Noblet and Frank Smets (eds), *The Euro at Ten – Lessons and Challenges*, European Central Bank, 2009.

When and if a proper framework is internationally adopted, sudden stops will not occur and the private component of external imbalances will be smoothly stable.

The remaining component, public sector imbalances, calls for adequate budgetary processes and rule, as explained in Section 0.

It is worth noting that current account balances are not even measured in other monetary unions. We do not know whether Ontario, Ohio or New South-Wales run current account surpluses or deficits and no one in Canada, the US or Australia thinks that we should know. Before the advent of the euro, the current accounts of Baden-Württemberg, Limousin, Venetia, etc. were not measured either. The case for measuring current accounts inside the euro area remains to be made.

Decomposition of current account imbalances (% of GDP)