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EURO-AREA GOVERNANCE: WHAT TO REFORM AND HOW TO DO IT

JUST AS IT WAS CELEBRATING its tenth anniversary, the euro area was hit by a financial crisis that started in the United States but rapidly spread to Europe. Economic and Monetary Union (EMU) was ill prepared to deal with the immediate crisis and the large fiscal, financial and structural

1. See, for example, Carney (2015). Recent ECB measures are welcome but may prove insufficient to prevent a lost decade.

2. See Sapir (2005). General policy complacency and the great moderation were further factors leading to the build-up of imbalances.

3. In particular, the bank resolution framework, the deposit insurance system and capital markets union are important elements for further work.

getting to grips with a European financial-cum-sovereign-debt crisis of considerable magnitude, which evolved in 2011-12 from the global financial crisis.

Another weakness of the euro area's economic governance architecture was that it lacked a mechanism to monitor and correct macroeconomic imbalances, except in budgetary policy. Enforcement of the deficit rules was inadequate, public debt sustainability received relatively little attention and private debt no attention at all. Similarly, external debt (and current account imbalances) was all but ignored. Moreover, no attention was paid to long-term and persistent ULC divergences.

The lack of focus on public debt sustainability led to two types of situations: (1) Fiscal rules were insufficiently applied, partly because there was inadequate understanding of the debt sustainability risks. Stricter application of the rules would have reduced future debt problems in Italy (and other countries) and in Greece, where enough was known to justify more forceful demands for corrective action. (2) Countries like Ireland and Spain that, although they abided by the fiscal rules, proved not to be immune to debt problems once the financial crisis erupted, revealing the huge build-up of private debt that led to problems for their public finances.

Governance mechanisms to address macroeconomic imbalances such as wage divergences do not exist in true federations such as the United States. The euro area needs mechanisms to address both competitiveness divergence and coordination of fiscal policy, because labour mobility is limited and fiscal policy decentralised.

CRISIS MANAGEMENT: WHAT WORKED AND WHAT DID NOT?

When the global crisis triggered the European crisis, the European policy system was largely unprepared. Crisis management during 2008-14 consisted of:

- A timely coordinated macroeconomic response in 2009 consisting of monetary-policy easing, the European Central Bank playing the role of unlimited lender of last resort to banks and a substantial increase in fiscal deficits.
- Hesitant and delayed crisis management, with countries losing market access combined with the gradual establishment and reinforcement of institutions that can provide financial assistance and impose conditions for providing that assistance.
- A gradual process starting with the 'Van Rompuy task force' (European Council, 2010) to strengthen EU surveillance mechanisms, resulting in new rules and mechanisms[4].
- When the sovereign debt crisis became more widespread and yields increased substantially in Italy and Spain, quicker fiscal consolidation and ECB support was implemented through the Securities Markets Programme (SMP) and Outright Monetary Transactions (OMT) programme.
- As banking and sovereign stresses reinforced each other and bank resolution was delayed, the European Council decided to establish a banking union to de-link banks from their sovereigns and increasing financial stability. The banking union project is now officially finished.

The crisis response has not delivered economic results for the euro area. GDP has not grown since 2008, and unemployment has increased[5]. Inflation has fallen substantially and in December 2014, area-wide deflation (of -0.2 percent) was recorded for the first time since 2009. Internal adjustment has proceeded, with current-account deficits shrinking substantially[6]. However, current account surpluses have, if anything, increased in Germany and the Netherlands, reaching 7 percent of GDP or more in 2014. There was some wage and price adjustment in the crisis countries, but relative prices between the three biggest euro-area countries – Germany, France and Italy – have adjusted only marginally. The very low area-wide inflation rate has not helped: the lower it falls, the more difficult it becomes to achieve the necessary adjustment.

The euro area has not delivered. What went wrong in the last seven years, contributing to such a bad economic performance? Besides the severe macroeconomic imbalances at the beginning of the crisis, the following problems can be identified:

- From 2011 to 2013, fiscal policy in the euro area was pro-cyclical. In 2014, fiscal

4. The so-called six-pack, two-pack, Euro+ pact and the Fiscal Compact. See http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

5. From 7.5 percent in 2007 to 12 percent in 2013 (11.6 percent in 2014).

6. Stressed countries including Cyprus, Greece, Ireland, Portugal and Spain reduced their current-account deficits on average by around 10 percentage points between 2007 and 2014.

countries and citizens of the monetary union has been regained by implementing measures that require no treaty change but can go a long way towards solving the current situation.

TRANSITION TOWARDS THE NEW GOVERNANCE SYSTEM

There is a pressing need to address two central problems in the euro area immediately. First, it is imperative to increase inflation and demand. Second, it is imperative to address the substantial divergences in ULC, in particular between France, Germany and Italy. This requires political consensus between governments because the ECB cannot continue to act alone to achieve these objectives. A reformed European Semester with better timing and a greater focus on euro-area recommendations could lead to a change in philosophy.

Correction of imbalances in both surplus and deficit countries is essential as is dealing with the stock of debt through a combination of more aggressive macroeconomic policies and messy debt restructuring where necessary.

In the next few years, it will be challenging to manage acute problems such as high debt, high unemployment and weak growth. Leaders should keep in mind a sense of direction towards a new governance model that cannot be achieved overnight. Yet, without a process starting now that will eventually lead to the necessary treaty changes, the daily management of the various crises may become impossible.

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judgement (Case C-370/12) opened the way for the creation of additional treaties without changes to the EU treaty.

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