DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

EMU Reforms: Centralisation vs. Decentralisation

NOTE

Abstract

The sovereign debt crisis is due to two major flaws of the euro area's architecture: a doomed approach to fiscal discipline and the lack of a banking union. Adopting a complete banking union has always been a requirement and is now urgently needed. The continuous additions of measures designed to strengthen the Stability and Growth Pact (SGP) will fail because this centralised approach is incompatible with budgetary sovereignty. The decentralised approach requires an unbreakable commitment to the no-bailout rule. The other proposals are not justified by economic principles. They may be justified by a political vision, we need more Europe. The timing of this proposals is worrisome, however, as we face a previously unheard loss of public trust in the European institutions.

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EXECUTIVE SUMMARY

The architecture of the euro area needs to be improved but the changes must rest on a proper diagnosis of what went wrong. Two flaws, identified before the launch of the euro but long denied, have now become plain to see.

The first one is the failure to achieve fiscal discipline. The reason for this failure is that the centralised approach of the Stability and Growth Pact (SGP) cannot work when Member States remain sovereign in budgetary matters. The strategy of continuously adding layers to the SGP has failed and will fail. The solution is to decentralise the approach. It should rest on two pillars: 1) national institutions and rules dedicated to fiscal policy and 2) the no-bailout rule. Inadvertently perhaps, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is leading to national institutions and rules dedicated to fiscal policy. What remains to be done is to adopt an unbreakable and unconditional commitment to implement the no-bailout rule.

The second major flaw was the refusal to recognise that the ECB is the sole lender of last resort to banks. A lender of last resort must be informed in real time of the situation in every bank or institution that it may have to rescue. The rescue itself requires the authority to intervene inside the institution and a burden sharing agreement. In other words, the euro area always needed to a complete banking union.

The Excessive Imbalance Procedure (EIP) and further proposals to coordinate structural policies are justified by a misguided interpretation of the crisis. Arguing that competitiveness losses have led to current account imbalances, the proponents of the EIP and now of a new coordination procedure fail to recognise that the observed changes in competitiveness and the current imbalances are not exogenous but the predictable consequence of excessive demand. An effective fiscal discipline arrangement and a complete banking union will greatly reduce the risk of renewed unsustainable demand.

Another argument to defend the EIP and economic policy coordination is the presence of externalities. It is not the case that any externality justifies intervention. The externality must be non-pecuniary whereas structural policies have effects adequately captured by relative prices. In addition, the externality is negative – one country's reform hurt others – which imply too much reform activity in the absence of coordination. This does not seem to be a serious threat at this stage.

1. INTRODUCTION: EXISTENTIAL CHOICES

The silver lining of the sovereign debt crisis is that important flaws in the architecture of the monetary union are now officially recognised after 15 years of denial. In its contribution to the soon to be released Four Presidents' proposals, the European Commission's '**Blueprint'**[1] **lists four problem areas**:

1. **Weak SGP:** '*The SGP was insufficiently observed by the Member States and lacked robust mechanisms to ensure sustainable public finances.*'

2. **Lack of coordination:** '*The coordination of national economic policies beyond the budgetary area relied on soft instruments – peer pressure and recommendations – and had a limited impact on the action of individual euro area Member States. The instrument was therefore too weak to counter the progressive opening of competitiveness gaps and growth divergences.*'

3. **Financial Markets:** '*Along with new approaches to risk transfer in the financial system [the equalisation of interest rates] resulted in globalised excess liquidity, a pervasive search for yield and ultimately a severe mispricing of risk of both private and public assets.*'

4. **Banking Oversight:** '*Despite the increased market integration, the responsibility for prudential supervision and crisis management remained predominantly at the national level.*'

While this list amounts to a partly erroneous diagnosis of the root causes of the crisis, it sends a clear message: the monetary union needs and overhaul which will increase its degree of centralisation. Put differently, the problems originated with too much sovereignty. Sovereignty was misused and resulted in fiscal indiscipline, wage and price slippages, excessive credit growth and poor banking supervision. The obvious solution is to aim at more transfers of sovereignty, which the Commission proposes to do step by step.

There is no doubt that the architecture of the monetary union was imperfect and that these imperfections have led to the crisis. It is necessary, therefore, to deal with these limitations, and to do so relatively fast to avoid a new round of severe shocks. A very important additional reason for plugging the monetary union's holes is that the crisis is far from over. In many ways, the worst is still to come. Policy responses to the crisis so far have involved violating the no-bailout clause, creating a massive amount of moral hazard. With approaching debt repudiations, the amount of moral hazard will further grow. The only response is to make sure that such a crisis will never happen again, which requires changes to the architecture. This conclusion stands in stark opposition to the view that there should be no response if the price is more moral hazard.

It is encouraging, therefore, that the principle of a reform of the monetary union be accepted. However, the risk is that the wrong solutions be adopted in response to a misleading diagnosis and motivated by unrealistic political aims. At stake is the very survival of the euro and, as we start to witness, of the European Union as we know it.

The Union has been and remains under construction. The goal is and will be a '*more perfect Union*'. A more perfect Union, however, does not necessarily more centralisation and less sovereignty. Sovereignty transfers are delicate, especially at a time when public opinions view '*Europe*' in alarmingly negative ways. Indeed, as Table 1 shows, while support for the euro has declined slightly since the onset of the crisis, trust in the EU and its institutions has collapsed. It is odd, therefore, that these same institutions attempt to increase their

[1] See European Commission (2012); http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf.

own power, especially at a time when nationalist forces are on the rise in nearly every Member State. In that sense, these attempts are dangerous.

This note argues that the Commission's diagnosis – which reflects views largely shared by the establishment, including many national governments – is incorrect and self-serving. In addition to proposing a different diagnosis, this note also suggests a different method to think about the necessary reforms: taking as given the political impossibility to achieve large transfers of sovereignty at this stage, what are the changes that will remedy the monetary union's flaws?

Table 1.: Changes in net trust in European institutions compared to changes in net support of the euro in the EA-12, 2008-2012

Comparison	Spring 2008	Spring 2012	Spring 2012 - Spring 2008
Net trust in the ECB	29	-18	-47
Nett rust in the EU	14	-32	-46
Net trust in the EP	27	-7	-34
Net trust in the EC	21	-11	-32
Net support of the euro	**40**	**33**	**-7**

Source: Roth et al. (2012); http://www.voxeu.org/article/crisis-and-public-support-euro
Notes: Updated version of Table 1 (by EB77-Spring 2012) in Roth, Jonung and Nowak-Lehmann (2012). ECB= European Central Bank; EU= European Union; EC= European Commission; EP= European Parliament.

2. GETTING THE DIAGNOSIS RIGHT

The crisis is not entirely bad luck even though the Great Financial Crisis that originated in the US in 2007 has triggered it. There were latent flaws that were either denied or poorly addressed. As reforms are under way, denials and misguided interpretations should not be allowed to prevail. This section uses the Commission's 'Blueprint' list of shortcomings – see above – to propose an alternative diagnosis.

2.1. A weak SGP

There is little doubt that the SGP has failed to promote fiscal discipline. Faced with repeated failures, policymakers have sought to continuously strengthen the SGP by trying to make it more automatic, to widen its scope, to increase the pressure on national governments and parliaments and to make the fine penalty easier to impose. Every successive failure has been seen as a proof that the SGP was not yet strong enough. Every reform has been announced as the solution. The conventional wisdom remains unchallenged. And yet, there is a simpler interpretation of the foreseen repeated failures of the SGP: it is structurally doomed to fail.

The reason is simple. Commitments, pressure and even fines will never override national sovereignty in budgetary matters. Governments and their Parliaments retain the last word on every single aspect of their budgets. It is national politics that drive national budgets, not European politics. Outside pressure has little impact on national politics or no impact at all.[2] As long as sovereignty remains national, the SGP will never be strong enough. The Six-Pack and Two-Pack approaches effectively attempt to undermine national sovereignty without doing so formally. This is why, ultimately, these approaches will fail as previous versions of the SGP did.

2.2. Lack of coordination

The conventional wisdom also considers that a key factor contributing to the crisis was the build-up of current account imbalances, caused by divergences in labour costs that could not be corrected by exchange rate adjustments. This is why the Macroeconomic Imbalance Procedure (MIP) has been adopted as a way to achieve *'coordination'* in the relevant policies. Not only is the diagnosis wrong but also the policy prescription is ill conceived.

The proposed diagnosis considers that these imbalances are exogenous. Somehow prices and wages followed divergent paths, leading to divergent degrees of competitiveness and to current account imbalances. But why did wages and prices diverge? Unable or unwilling to identify the source of these divergences, the MIP therefore relies on a broad range of indicators. It does not specify which instruments will be used.

There may be good political reasons to avoid specifying the cause(s) of cost divergence. As long as they are seen as exogenous, the only explanation must lie with national labour institutions: wage bargaining processes, structure of trade unions, social policies in matters of employment and unemployment, etc. Since it would be not just illusory but politically dangerous for *'Europe'* to get involved in these deep aspects of sovereignty, the MIP is intentionally vague. Countries could be fined for failing to achieve targets but *'Europe'* will not say precisely what should be done to avoid a fine. Like the SGP, the MIP is doomed to fail.

[2] The situation is radically different when a country receives conditional support as in IMF or Troika programmes. In such a situation, sovereignty is partially and temporarily suspended. Even then, as the long experience of the IMF shows, national authorities never fully abide by the conditions that they have accepted.

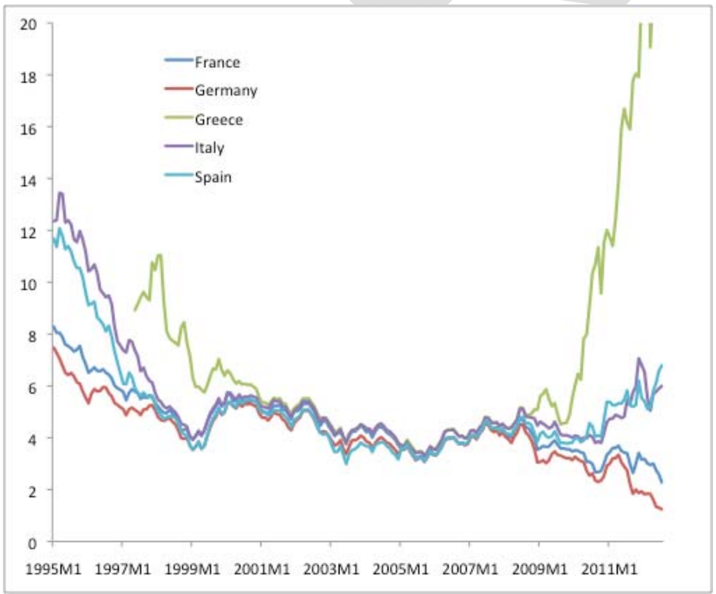
From an economic viewpoint, the diagnosis is wrong. Wage and price divergence did not come about exogenously. Wyplosz (2012a) shows that both costs and current account imbalances were the consequence of divergent demand paths. The crisis countries went through a period of rapid growth fuelled by unsustainable public (Greece, Portugal) or private (Ireland, Spain) demand, which resulted in classic Phillips-curve cost increases and in external deficits. The first source of unsustainable growth was fiscal indiscipline, unchecked by a powerless SGP. The second source was a classic credit boom due to banking oversight failures. Solving these policy failures will make MIP – and policy coordination - unnecessary.

2.3. Financial markets

The convergence and divergence of government bond spreads (Figure 1) is spectacular and well known, but the interpretation is complex. One often mentioned reason for the convergence is that the ECB was purchasing these bonds at par during its routine refinancing operations, in effect providing a guarantee. This is not necessarily true. Once the crisis started and interest rates started to diverge, the ECB applied haircuts. Ex post, therefore, there never was a guarantee. Still, the markets may have believed in such a guarantee, much as they never believed that the no-bailout clause would be applied. At any rate, the ECB never suggested that it was guaranteeing these bonds; in fact, on numerous occasions, the ECB warned the markets that they might be mispricing some public bonds.

The problem, then, lied with the markets. But did they really misprice bonds? Ex post, again, this seems self-evident. Another interpretation is that the euro area is another victim of the phenomenon of self-fulfilling crises. In the mid-2000s, no one was seriously predicting either state defaults or a breakup of the euro area. There was no reason why markets should have priced a default risk or a redenomination risk. Given then available information, the markets were perfectly right. Then, following the US financial crisis and quickly rising public debts, the possibility of a state default could not be ruled out. The markets rationally opened up some spreads. The spreads then increased, as policy responses were inadequate. Once again, the markets were perfectly right.

Figure 1.: Long-term bond rates



Source: AMECO on line, European Commission.

This is not to say that the markets are always right, not even that their panicky over-reactions to misguided policies did not contribute to the crisis. There was a market failure, but this is the perennial case of information asymmetries that is the source of panics. The policy response is to properly regulate markets.[3]

2.4. Banking oversight

With one currency, we have one central bank, and one central bank means a single lender in last resort. Even though central banks routinely deny that they stand ready to act as lender in last resort, they must do so. If there was ever a doubt about that, it has been dispelled by the Great Financial Crisis of 2007-2008. It follows that the ECB is the lender in last resort for all euro area banks, big and small alike.

The time-honoured rules of engagement for lending in last resort – the Bagehot rules – is that the central bank must act fast, forcefully and, for moral hazard reasons, rather ruthlessly. This requires that the central bank has complete information in real time and that an authority be given the power to resolve the bank. Since European money will be put at risk, it also follows that we need a European supervisor, a European resolution authority and a burden-sharing arrangement (which may take the form of a European intervention fund and/or a collective deposit guarantee mechanism).

This was known even before the launch of the euro. It is now recognised. Making it happen is the next hurdle as powerful vested interests are strongly opposed. The issue is not one of economic analysis anymore.

3 Blaming the rating agencies is another case of misunderstanding how financial markets work. These agencies merely follow and formalize market sentiments. It has been suggested to establish a European 'official' rating agency: this would be the equivalent of official news agencies in undemocratic countries.

3. THE CENTRALISATION/DECENTRALISATION CHOICE

An ideal goal is the evolution toward a United States of Europe. This would be a true federal arrangement where Member States retain power for matters of local interest (education, transportation, health, etc.). Of course, those who regard the nation state as a better solution loathe a federal arrangement. As is well known, the *'Monet method'* is to eschew this debate and solve the problems as they arise without having to decide on the ultimate aim. Yet, the choice of what should be centralised and what should remain at the national level is a classic issue, with some guiding principles (e.g. the subsidiarity principle) but few clear-cut recommendations. There are also vested interests. All four Presidents are primarily Europeans. It is no surprise, therefore, that they see the crisis as an opportunity to go the next step towards more central powers.

3.1. Banking oversight

The arguments presented in Section 2.4 support a complete centralisation of banking oversight, including regulation, supervision, resolution and burden sharing. Centralisation here is a direct consequence of the adoption of a single currency. This means that, in principle, this only concerns the euro area. Yet, there is no reason to exclude non-euro area member countries that wish to join, even though the ECB cannot be their lender in last resort (since it does not create their currencies).

3.2. Fiscal discipline

In principle, the recent reforms of the SGP, including the TSCG, are meant to be adequate and to deliver fiscal discipline. The SGP and its various amendments all aim at a centralised approach to fiscal discipline. The rules are collectively agreed upon and the implementation is assured by the Commission's surveillance backed by fines. The arguments presented in Section 2.1 suggest that this solution will not work because Member States remain sovereign.

A decentralised alternative relies on incentives. It is based on a complete and unconditional restoration of the no-bailout clause. As explained in Wyplosz (2012b), such a clause provides incentives to Member States to adopt and implement themselves adequate fiscal rules. The US experience suggests that a credible no-bailout rule is enough to establish fiscal discipline (Henning and Kessler, 2012).

The TSCG is generally seen as an additional layer of reinforcement of the SGP. It can be seen as a first step towards the decentralised approach to fiscal discipline since it mandates member governments to set and enforce their own fiscal rules. All that would be needed to achieve decentralisation would be an unbreakable commitment to abide by the no-bailout rule.

3.3. Fiscal capacity

Proponents of a euro area fiscal capacity justify it as a way to help Member States to deal with shocks, be they country-specific (asymmetric) or euro area wide (symmetric). Under current arrangements, monetary policy deals with symmetric shocks – with the proviso that price stability is not jeopardised – while national fiscal policies deal with asymmetric shocks, possibly too with symmetric choice – with the proviso that fiscal discipline is maintained over the business cycle. The inspiration is often the example of existing federations where the federal budget both fulfils a collective counter-cyclical function and acts as an insurance system in the case of asymmetric shocks.

A fiscal capacity is therefore a plus, but it is not necessary. Under the assumption that they will henceforth be fiscal disciplined and that their debts will be low, Member States will be able to borrow freely when they face adverse shocks. Fiscal rules will then ensure that the debts are repaid. A euro area fiscal policy would then be redundant.

There remains the argument that some Member States currently have public debts far too large for them to be able to borrow freely when needed. Indeed, in this case, a euro area fiscal capacity would be useful. However, it is in each country's interest to bring its public debt to a comfortable level. The fiscal capacity could therefore be seen as a temporary arrangement that would borrow on behalf of Member States that have no or limited market access.

3.4. Structural policy coordination

The mistaken view, that exogenous losses of competitiveness have caused current account imbalances, has been used to introduce the EIP, is also seen as a justification for coordinating structural policies. The Commission envision an elaborate procedure, which includes formal commitments and surveillance, along with warnings and fines.

A more serious justification is that structural reforms are a source of externality. Indeed, one country's successful reforms will enhance its competitiveness at the expense of unreformed countries. Yet, for two reasons, this form of externality does not call for collective action. First, this is a pecuniary externality since its effects will be mediated by prices (and labour costs). In this case, as is well known, the externality sets the incentives right: unreformed countries will have an additional reason to reform themselves. If they don't, they will suffer the consequences and the reformed countries will enjoy the benefits. The second reason is that the externality is negative. This means that, absent coordination, there will more rather than less reforms. The evidence is that this particular externality has been too small to generate an excessive amount of reform activity. Given resistance to reforms, this externality is in fact desirable.

4. CONCLUSION

With the exception of the banking union, the proposals to improve EMU are not justified by economic principles. They may be justified by a political vision, we need more Europe. The timing of this proposals is worrisome, however, as we face a previously unheard of loss of public trust in the European institutions.

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