

Lessons learned from the Global Economic and Financial Crisis.

Do we need a European Economic Government?

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Do we need a European Economic Government?



- In the current crisis the ‘existence’ of a single currency is not really an issue (exit from the € is neither possible nor convenient for any member)
- The role of the single currency in the general economy is in fact under discussion
 - Key question: What sort of euro do we want?
 - Depending on the answer the need of a European Economic Government will vary

What fiscal rules for what currency?



- Option 1: ‘mere pooling’ single currency that enhances the single market by eliminating FX risk.
 - Requires Economic Government to channel transfer and limit free riding
- Option 2: In addition to 1, the Euro as a stability-promoter mechanism (long term reduction in borrowing costs for both the public and the private sector of all EMU members).
 - This is a highly demanding environment that requires credible and stringent rules and institutions. i.e. It requires credible economic governance that provide effective coordination

What fiscal rules for what currency? (II)

- In Maastricht, EMU members chose option 2 and if anybody should want to change it they should be politically very explicit about it.
- I will assume the final aim is still option 2
- The current crisis has shown a complete failure in attaining the objective
 - The euro's original design relied on 4 pillars to accomplish it:

The original pillars of the single currency



- Credible and binding fiscal rules (SGP) applicable to all
- Reformist agenda to make economies more flexible and capable of absorbing asymmetric shocks
- Integrated financial markets that eased external financing constraints to growth of national economies
- A 'written in stone' no bail-out clause as a 'infinite punishment' to infringers

How the original design was politically blown up



- This original design was consciously eroded by intended policy actions
 - SGP application to 'core EMU economies' was waived in 2003 ('the stupidity pact') and then 'flexibilised' → loss of credibility of the preventive arm
 - The corrective arm of the original SGP was never applied (even in the case of Greece that has never officially met the 3% deficit criterion)
 - The peer pressure mechanism of the 'Lisbon Agenda' never worked by lack of political commitment to deliver true reforms

How the original design was politically blown up (II)



- Euro denominated capital markets are now nationally fragmented again due to the contradiction between global operations and national supervisory and rescue capabilities
 - The spread dynamics prove it
- The 'no bail-out' has been demolished by the sovereign debt crisis.
 - It is now reinterpreted in a weaker sense due to the European Stability Mechanisms

Restoring the euro pillars



- But if we still want the stability-expanding euro we must reinvent these pillars and make them 'incentive compatible' so that they work even when strong political commitment wanes
- Non fiscal pillars:
 - European Stability Mechanism as a limited liability backstop and a second best substitute of the original 'no bail-out'
 - Surveillance of macroeconomic imbalances + competitiveness pact
 - New EU-wide financial supervisory architecture
 - But it lacks true banking rescue capabilities (still national)
 - The “Who pays has to supervise” principle

EU efforts to restore the euro fiscal pillar



- New EU rules to ensure fiscal sustainability
 - New SGP (preventive and corrective arms)
 - Enhance national budgetary frameworks
 - Avoid new 'Greek black holes' staying undetected
 - Avoid expenditure consolidation based on cyclical tax revenues
 - Increase simplicity over 'technocratic intelligence' → in the preventive arm definition of 'prudent fiscal-policy making' based on potential growth proxy
 - More gradual sanctions and reduced political discretion

My assessment on what should be done to restore the euro fiscal pillar



- To recover lost credibility of EU fiscal rules
 - Fully automatic sanctions giving signals to financial markets
 - The reverse qualified majority voting of EU Council is not enough
 - Effective sanctions are those that correct behaviours →
 - Focus on the preventive arm
 - The most efficient financial sanction is market discipline
 - For this to work the preventive arm of the SGP should provide relevant information to capital markets
 - Capital requirements for banks holding debt of countries breaching the SGP should consume more capital
 - ECB haircuts for the REPO transactions with sovereign debt as collateral should take into account the degree of compliance with SGP provisions

My assessment on what should be done to restore the euro fiscal pillar (II)



- Discriminate fiscal problems stemming from banking crisis from other sources of fiscal imbalance
 - Locating banking rescue capacity on national budgets fragments financial markets in stress times and is inefficient in a monetary union
 - Avoids full development of the single market and precludes international productive specialization
 - Does the Irish case have something to do with non prudent fiscal behavior? No
 - Proposal: Euro-wide banking rescue capability based on binding agreements by EMU member countries linked to contributions to systemic risk is needed (and it is not on the political agenda)

My assessment on what should be done to restore the euro fiscal pillar (III)



- Direct translation of EU fiscal constraints to national 'constitutional frameworks' (specially relevant in highly decentralized countries)
 - The coordination and free riding problem suffered by the EMU is multiplied at the subnational level
 - The explicit translation of EU fiscal rules in national constitutional frameworks will ignite the much needed 'National Pacts for Europe', that is, the clarification to national public opinions (the existing demos) of the commitments they legitimately acquired when entering the Euro
 - There is no external imposition on the Euro. There is only compliance with the pre-agreed commitments all countries made to each other.
 - The imposition (economic dictat) rhetoric is politically lethal

My assessment on what should be done to restore the euro fiscal pillar (IV)



- Technocratic shortcuts are neither politically possible (see regional elections in Germany) nor desirable (see Greece).
- Economic Governance is by essence a truly political issue



My assessment on what should be done to restore the euro fiscal pillar (V)



- SGP sanctions should have a political nature not a financial nature
 - Leave the financial sanction to market discipline with appropriate information and incentives and concentrate political pressure on sanctions of a political nature
 - E.g: Proposals to waive Council voting rights
 - Legally imposed financial sanctions have proven to be ineffective and non credible.
 - On the contrary, rising spreads have proven to be effective and credible

Thank you very much.

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