



## EU Economic Governance Reform: Are We at A Turning Point?

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## Introductory remarks

*The sovereign debt crisis is creating enormous anguish in the EMU. Not surprisingly, emergency measures continue to be used at a time when a sort of economic recovery seems to be underway. Against this background the European Council summit of last October considered a Task Force report with a telling name: "Strengthening economic governance in the EU". This document is to be examined in conjunction with the governance reform proposals issued by the European Commission at the end of September and related documents. For the depth of this financial crisis and the "Great Recession" have forced EU governments and EU institutions to take a hard look at the governance structure of the Union. But it would be wrong to say that this demarche is an attempt to explore a terra incognita. From the very beginning of the European Monetary Union (EMU) there was some discomfort with its institutional underpinnings and there were misgivings regarding its optimality as a currency area. This explains why a train of thought underlines a political rationale, too, for the creation of the EMU. Likewise, criticism regarding the way regulation and supervision have been established in the Union is not of recent vintage. And insufficiencies of the Stability and Growth Pact (SGP), with almost all member states flouting its rules at various points in time, have been repeatedly pointed out. This said, however, the flaws of financial intermediation have been less tackled by policy-makers and central bankers for reasons which, partially, are to be found in a paradigm which has dominated economic thinking in recent decades. This paper focuses on roots of the huge strain in the EU (EMU) and main policy issues ensuing from the current crisis. It also looks at the stake NMSs have in a reformed EU economic governance structure. The challenges for EU economic governance reform are to be seen from a broad perspective: the crisis of the financial intermediation system; the sub-optimal character of the EMU; institutional and policy underpinnings of the EU (EMU) including the regulation and supervision of financial markets; the capacity of the EU to deal with global imbalances, etc. Nota bene: there is a "political reality" which constrains decisions in the EU; the latter is not a federal state and what appears to be rational when defined strictly economically may clash with implications of the political configuration of the Union.*

## 1. Roots of the strain in the EU and policy issues

### 1.1 A flawed financial intermediation system

Financial stability has staged a formidable comeback on the policy-making agenda in advanced economies. Episodes of financial crises did occur in emerging economies during the past century recurrently. But they were thought about as a specific phenomenon of poorly developed financial systems and fragile institutions. Once the crisis engulfed almost the whole industrialized world<sup>1</sup> a watershed chain of events has taken place. The current crisis has shown that something is structurally wrong with financial markets. The financial crisis cannot be explained only by years of cheap money and growing imbalances in the world economy. Mistakes in macro-economic policy were accompanied by gross abuses of securitization, excessive leverage, abnormally skewed incentives and a loss of moral compass, inadequate risk-assessment models and failures to check for systemic risks, a breakdown of due diligence and an almost blind belief in the self-regulating virtues of markets. *Structure* is key in understanding the current crisis. For, on one hand, it can derail even brilliantly conceived policies; on the other hand, for it can shape policies wrongly. For instance, complacency vis-à-vis the expansion of financial entities overexposes economy to major risks (like it happened with Iceland, Ireland, UK, etc). Or take a premature opening of the capital account, as it happened in numerous emerging economies, and the policy approach which propounded total deregulation of financial markets as a means to foster economic growth.

Financial intermediation, as it has evolved during the past decades proves that not all financial innovation is good, that inadequate risk and business models have been used by banks and other financial institutions. Quite a while ago warnings were sent regarding the growing opaqueness of markets due to securitization and off balance sheet activity. Lamfalussy noted that financial integration made “crisis prevention and handling it more difficult” (p.73). Moreover, the financial industry has become oversized in not a few economies. The paradigm shift which is, currently, underway is rediscovering systemic risks: the complexity and inter-connectedness of financial markets, contagion effects, “Minsky moments”<sup>2</sup>. But there is need to make here a distinction between two opposed cognitive approaches: one that believes that nothing can be done about the evolution of markets, whatever the way financial innovation goes; and another approach, which does not take the complexion of markets as God given and has misgivings about a range of financial innovations. Networks do not mushroom accidentally only; they are also shaped by policies. As Haldane, the director of research at the Bank of England remarked: “Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness...”(p.31).

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<sup>1</sup> Local financial crises did happen in western economies in recent decades: in Scandinavian economies in the early 90s, in the US (the Savings & Loan Associations crisis) in the 80s, etc. Canada has been much less hit by the current crisis owing to its better regulated and supervised banking system.

<sup>2</sup> These are moments at which, according to Minsky, financiers lay waste to the economy.

## 1.2 The EMU: sub-optimality and institutional and policy weaknesses

Nowhere is more glaring the impact of *structure* than in the European Union, in the EMU in particular. For, in this area massive cross border operations take place while national prerogatives in regulation and supervision, in tax policies stay, basically, in national hands. In addition, the EMU is still far away from an optimal currency area<sup>3</sup>.

The current crisis has highlighted the inadequacy of existing institutional and policy arrangements and a stark fact: *that not all problems have a fiscal origin* (though they may end up, ultimately, as public debt). These arrangements have favored the accumulation of internal imbalances against the background of one-sided, inadequate policy tools. The “one size fits all” monetary policy of the European Central Bank (ECB) could not prevent excessive capital, frequently of a speculative nature, flowing into less developed areas of the EMU, in the EU as a whole. Resource misallocation and bubbles were stimulated in this way. Likewise, an increasing entanglement of mutual exposure among financial entities<sup>4</sup> has happened while burden-sharing arrangements in case of a failed entity were missing. Ironically, the ECB has been forced to turn into a de facto lender of last resort to various governments which have tried to prop up financial institutions, be it indirectly (by accepting a wide range of bank collaterals). Contagion effects have reinforced the sentiment that institutional and policy arrangements are precarious in the EU. Systemic risks, which have been engendered by “too big to fail” cases, are compounded by effects of a “too big

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<sup>3</sup> The optimum currency area (OCA) theory says that the adoption of a single currency pays off when a single monetary area is highly integrated economically and has the capacity to adjust quickly to asymmetrical shocks. There are five core OCA properties namely: wage and price flexibility, trade integration, cyclical convergence, factor mobility, and fiscal federalism, which are used to assess an OCA area. On these accounts, the euro area still seems to have way to go for an efficient functioning. In the EU wage setting continues to be done, predominantly, at the national level, and quite often at the sectorial level. Within the euro-area real wages have tended to be downwardly rigid with a relatively high level of indexation. Although nominal interest rates have largely converged, there is a wide discrepancy among real interest rates of the euro zone members. Although business cycles synchronization appear to have increased within the eurozone countries, much of it has to do with the fall in the amplitude of global business fluctuations during the past decade, which benefited from low interest rates, high economic growth and low inflation. Considerable structural differences remain at the euro-zone country member level. European labor mobility remains fairly limited, despite persistent differences in regional unemployment. Given an independent EU monetary authority, the ECB, the argument for a EU Fiscal Authority appears to be compelling. This would create more room for maneuver for the fiscal mechanisms of purchasing power transfers in the face of idiosyncratic shocks. It would also place less pressure on the ECB when dealing with regional divergences. But the EU budget is little more than 1% of the EU GDP, providing limited scope for stabilizing cross-state transfers. Moreover, a large part of that budget is allocated towards spending on the Common Agricultural Policy and Structural Funds, which are weakly related to cyclical fluctuations in the individual member states.

<sup>4</sup> Banks outside of Greece, Ireland, Portugal and Spain hold 2 trillion euro in debt instruments from these countries, which underscores the systemic risk to the financial system if one or more borrower countries fails (data researched by Jacques Cailloux, cited by Kanter)

to be saved”<sup>5</sup> syndrome. This crisis is also one of deep financial integration, which the intensity of the sovereign debt crisis mirrors quite glaringly<sup>6</sup>. Thence arises the need for deep reforms of the EU governance structure.

In Europe, integration, with its financial component, was seen as a principal way to achieve catching up. And this economic philosophy brought about benefits. But it has also entailed vulnerabilities, which, therefore, are not to be linked exclusively, with weak policies. For even countries which were quite prudent budget policy-wise and limited their external disequilibria (ex: the Czech Republic, Poland, etc) were caught into the crisis maelstrom. Big bubbles and much investment in non-tradeable goods sectors occurred in several NMSs<sup>7</sup> following the opening of the capital account. Inadequate regulatory and supervisory arrangements operate in their case, too, in view of the size of cross-border financial flows and the domination of local markets by foreign banks. Outside Europe and learning from previous crises, emerging economies tried to forestall shocks by the accumulation of foreign exchange reserves as a buffer (a high premium was attached to them); uphill financial flows were seen as a cost for the build up of a wherewithal capacity in the advent of unanticipated shocks. Industrial policy aims, too, played a role in this respect.

#### Regulation and supervision of financial markets in the EU

Late in 2008 European leaders continued to be mired in the illusion of a relative robustness of EU economies; they seemed not realize the extent of EU headquartered big banks’ involvement in the origination and distribution of toxic financial products, the interconnectedness of financial markets, the presence of a shadow banking sector in Europe as well. In addition, the distribution of responsibilities between home and host country and the inexistence of detailed burden-sharing arrangements in the event of a crisis has been a major handicap for the single market under conditions of deep financial integration.<sup>8</sup> Under current arrangements, responsibility for the stability of financial institutions belongs to the supervisor of the country where they are headquartered whereas responsibility for the stability of financial systems belongs to the supervisor of the host country. This crisis reinforces the idea that a common rulebook, more integrated supervision, and a common framework for crisis resolution are all needed to match the degree of financial integration. On the other hand, the burden-sharing issue prompts national

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<sup>5</sup> The overexpansion of some financial entities has dwarfed the capacity of home states to intervene in order to deal with systemic risks (Gros and Micossi).

<sup>6</sup> Reinhart and Rogoff’s observation that deep financial crises are followed by sovereign debt crises is quite meaningful in the case of a highly integrated monetary union

<sup>7</sup> A Bruegel publication highlights this type of capital flow into the Baltic economies, Romania, Bulgaria (Becker et al., “Whither economic growth in Central and Eastern Europe...”, especially chapter 2).

<sup>8</sup> As the de Larosiere report says, ‘The absence of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers’ protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place’ (p. 76).

governments and supervisors to think more along national lines, in view of their accountability toward national tax-payers. How this contradiction will be addressed is essential for the future of European integration.

### *1.3 Redistribution of power in the world economy*

The Lisbon Agenda was enacted in 2000, as a EU response to Asia's growing assertiveness in the world economy. In a global space in which competition is taking place, frequently, via zero-sum games, there was evidence that the EU, as a whole, is losing ground. Europe 2020 is a resuscitation of the Lisbon Agenda, which was hardly a success. But one of the lessons of the past decade is that national policies make a difference. The results of Scandinavian countries, of Germany in undertaking reforms with a view of improving competitiveness are a proof in this regard.

### *1.4 Global imbalances*

Global imbalances enhance crises, which produce contagion effects. Can the EU push for a reform of the IFIs and of global arrangements which should limit dangerous global imbalances? The EU would gain in persuasion and bargaining power in the G20 to the extent it can deal with its own problems effectively. Yet, conflicting views and interests among EU member states reduce its internal cohesion and harm its power projection externally.

There are lessons which policy-makers need to learn from this crisis:

- price stability is not sufficient for securing financial stability
- fiscal prudence is not sufficient for securing economic stability;
- unless financial markets are properly regulated and supervised they pose enormous systemic risks; this is particularly valid in a deeply integrated area such as the EU;
- private sector overindebtedness creates systemic risks when it involves "too big to fail" financial entities;
- ways have to be found so that private investors bear the risks they assume (for the rescue programs have increased moral hazard); banks (their share-holders, bond-holders) should not take for granted that whatever they do tax-payers' money stays behind them;
- deep financial integration demands stronger regulation and supervision at the EU level;
- because of deep integration contagion effects hardly leave one immune to the effects of a crisis;
- the incompleteness of the policy regime in the EU (EMU);
- deep financial integration collides with the reality of national tax prerogatives;
- policy coordination needs to take into account EU-wide interests;
- trustworthiness among member states is essential for the sale of preserving the common public goods;

- national policies do matter for improving competitiveness, even when the room of manoeuvre is quite limited;

We are living in an increasing uncertain world, which diminishes policy effectiveness and asks for “policy space” (like fiscal space) in order to cope with “tail events” and non-linearities (Taleb).

## 2. The EU policy response

The EU policy response to the current crisis has two components. One is a crisis management endeavour, which has tried to curb the economic downturn and avert financial meltdown. The ECB has taken an active role in this, which has gone much beyond its usual mandate. The other component aims at reforming the economic governance structure of the EU. This second component (which relies on policy recommendations of the Task Force of the European Council and the EU economic governance package of the European Commission<sup>9</sup>, the de Larosière group report, the Monti report, etc) is manifold. Some measures aim at improving the regulation and supervision of financial markets – from a global perspective too. Other measures focus on weaknesses of the EMU as a currency area and revealed flaws of the SGP in tandem with a *prise de conscience* regarding “internal imbalances” in the EU. The overall goal is to achieve: greater fiscal discipline; a broadening of and more effective economic surveillance (which refers to macroeconomic imbalances and vulnerabilities); deeper and wider policy coordination (“the economic semester”); a scheme for crisis management; and stronger institutions for effective economic governance.

### 2.1 Dealing with macroeconomic imbalances in the EU

#### 2.1.1 Towards greater fiscal discipline

The sovereign debt crisis (ensuing from the financial and economic crisis) has heightened the *fiscal sustainability* policy concern at a maximum. Governments’ responses during this crisis and in other crisis episodes show that, in the end, trying to avoid a systemic collapse burdens the public debt. Consequently, strengthened fiscal discipline, as a primary element of the new policy framework, should be seen in conjunction with policies addressing macroeconomic imbalances in the EU. A stronger Stability and Growth Pact (SGP) is to be buttressed by better surveillance and better quality of the data gathered from EU member states. The new system would rely on a much stronger compliance regime via “financial and reputational sanctions”.

The preventive arm of the SGP considers the sustainability of overall public debt, while the corrective arm targets a budget deficit path which should bring down the debt to GDP ratio over time, in a consistent manner. The preventive component of SGP is to be added an “expenditure

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<sup>9</sup> This was made public on September 29th 2010. The European Parliament is expected to make amendments to this package

rule” aiming at limiting its annual growth in accordance with “a prudent medium term growth rate of GDP”, unless the excess expenditure is offset by measures on the revenue side. But “deterministic governance does not work in a stochastic world (Jean Pisani Ferry, p.2). If we accept this assumption the task of judging medium term dynamics for an economy gets more complicated and, thence, what is a prudent budget policy and an effective approach in dealing with overall imbalances.<sup>10</sup> And if this is the case a political haggling between member states and the Commission officials may be unavoidable. Could the Council solve it via the procedure of “reverse majority voting” (which says that a policy recommendation/sanction would be given to a state unless a majority of member states opposes it). This debate would clearly be linked with the introduction of sanctions for countries which are in breach of their budget policy obligations.

The corrective component is to be modified by making the debt criterion no less important than the deficit criterion (according to a Commission proposal). Thus, public debt over 60% of GDP would force a country to bring it down at a pace of one twentieth of the excess over the previous three years. But making this modified rule work is not uncontroversial. For instance, asking a country to bring down its debt during a recession period may be self-defeating –owing to the procyclical nature of debt to GDP ratios. Nonetheless, as the current crisis has shown a grace period may be allowed to the extent a higher budget deficit is caused by automatic stabilizers while a government mounts a serious effort at reforming budget expenditure.

The criterion of public debt is to be better reflected in the budgetary surveillance mechanism with a focus on “fiscal sustainability”. This is because of the rise in public debts following bank rescue programs, apart from the impact of population aging and other factors. There will also be more attention given to the interplay between debt and deficit. Quite likely, the TF and the Commission experts had in mind Ireland and Spain when thinking of this aspect. For both these two countries, as members of the EMU, did not show budget profligacy before the crisis.

Except Hungary, NMSs do not have large public debts. But budget deficits have gone up dramatically in the wake of this crisis. In several NMSs problems in the private economy were transmitted to the public sector through reduction in the level of output (and thence, diminished budget revenues) and in the form of increased off balance-sheet public obligations and, especially, of increased deficits as a result of the deleveraging process in the private economy. As a Bruegel publication underlines, fiscal consolidation has to consider the risk of adding public deleveraging to the ongoing private deleveraging, for this could harm economic recovery<sup>11</sup>.

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<sup>10</sup> In the EMU, in particular, the room of manoeuvre of policy-makers is quite limited and adjustments have to occur, principally, via wages and product and service prices.

<sup>11</sup> If growth remains depressed owing not only to low private but also public demand, these countries may face problems similar to those that Latin American countries went through in the 1990s. Then, interest rates shot up and growth remained depressed for years as governments ran high primary surpluses in order to repay their accumulated debt obligations (Becker et al., “Whither economic growth in Central and Eastern Europe”, p.131)

But there is also a risk of basing budgetary strategy on overly optimistic assumptions and of endangering the sustainability of public finances. Because a dramatic rise in budget deficits, in the wake of the current crisis, may not be a temporary affair. Particularly where there has been resource misallocation for years and structural budget deficits were hidden by bubbles, non-sustainable economic growth (this is, arguably, the case of Baltic countries, Bulgaria, Romania). Consequently, fiscal consolidation programs are necessary where there is a permanent loss of output and economic growth prospects have been impaired. Moreover, substantially increased borrowing interest rates (not least owing to worsened international credit markets and crowding out effects exerted by big economies' borrowing needs) bring the spectre of a debt service snowball effect to the fore<sup>12</sup>. For instance, a positive differential between the GDP growth rate and the interest rate should be a sufficient condition for stabilizing the size of public debt provided this differential is superior to the budget primary deficit as a share of GDP. But, if there is a jump in the interest rate this differential can become inferior to the primary deficit, or even turn negative, and if this reversal persists the debt service turns into a destabilizing element in public debt dynamics. This is why, in most NMSs EU structural and cohesion funds get an additional strategic dimension --as a means of combating the influence of expenditure reduction (out of own resources) on aggregate economic activity and of bolstering public investment in a period of distress, of fiscal consolidation. These resources would help prevent fiscal consolidation becoming pro-cyclical during a deep recession<sup>13</sup>; they could also raise the growth potential of economy, which was lowered by the deep crisis. The IFIs and EU supported adjustment programs in NMSs have, arguably, not paid sufficient attention to the strategic role of EU structural and cohesion funds in this new context. Likewise, how contributions made to private pensions schemes (which is part of the pension system reform) is accounted for in the measurement of structural budget deficits matters a lot.

The SGP should take into account the specific macroeconomic conditions of the countries in the region and, where necessary, conditional lending and measures to raise the absorption of EU funds should balance the need for fiscal consolidation in a period of private-sector deleveraging. The EU should support the adoption of national budgetary frameworks that promote sustainability and are conducive to counter-cyclical policies.

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<sup>12</sup> Countries can default in spite of not having excessively large public debts (Sturzenegger and Zettelmeyer)

<sup>13</sup> Romania is a particular case, in this respect, owing to its pretty low level of budget revenues (cca 30% of GDP while in almost all other NMSs this share is above 37-38%). It shows a significant jump in its public debt --from cca 22% at the end of 2008 to 30.1% in 2009 and an estimated 35% of GDP in 2010. Its debt service also went up considerably: from 0.8% of GDP in 2008 to 1.2% in 2009 and an estimated 1.6% in 2010, while the primary budget deficit rose to -7.1% in 2009 from -4.6% in 2008. The rise in the share of short term debt is also to be taken into account.

The automaticity of sanctions is a tremendously contentious issue<sup>14</sup>. The Council Summit of October 2010 ended up with a compromise formula that dented the initial suggestion to have full automaticity of sanctions, which, reportedly, was supported by the European Central Bank. On the other hand, the compromise seems to reflect Germany's insistence that a debt resolution scheme involve the private sector in eventual losses. As some point out, the "no bail out" clause (no co-responsibility for public debts) of the EMU arrangements is not synonymous with a no assistance provision. As a matter of fact, were assistance to be given on the basis of a strong program of reforms/adjustment – with proper conditionality attached—it would make full sense. Moreover, the EMU has likely reached a threshold from where solitary exits are pretty costly for the Union as a whole--because of deep financial integration, in particular.

A legitimate question is the suitability of an adjustment program. For there could be conflicting views in this respect, especially at a time when financial markets behave quite nervously and an economy can easily get into a spiral of vicious circles. Just think about CDS quotations during 2010, which are highly indicative of how a debt service (in EMU southern economies, mainly) can get out of control, in spite of attempts at fiscal consolidation.

The timing of the new governance framework implementation differentiates between eurozone and non-eurozone member states. One can say that a faster introduction in the EMU is justified by the deeper economic integration. On the other hand, intense contagion effects would ask for a stern EU wide surveillance system and policy coordination.

### 2.1.2 Broadening economic surveillance and dealing with macroeconomic imbalances

Broadening the scope of monitored macroeconomic imbalances and asking for related policy corrections is directly linked to the acknowledgement that competitiveness gaps strain the EMU<sup>15</sup>. Procedure-wise EU officials can use the logic of excessive budget deficit warning. As a matter of fact the Commission proposes that an "Excessive Imbalance Procedure" (EIP) be available, which should be backed by financial sanctions for EMU member countries. But as an analytic endeavour and making it operational, this is a highly demanding new exercise for EU institutions, for the Commission in particular. The latter has to come up with a scoreboard of indicators<sup>16</sup> to be monitored constantly and prepare early warning recommendations for the

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<sup>14</sup> In the preventive part of the SGP sanctions would be consist of early warnings and, subsequently, interest-bearing deposits on the infringing EU state; in the corrective part and unless the State has not taken effective action to correct the excessive deficit "a fine will be imposed", including a variable component related to the deficit level.

<sup>15</sup> Duillien argues in favour an additional "stability pact", which should limit the size of current account imbalances inside the euro-area

<sup>16</sup> Among these indicators one would range: current account balances, net foreign assets, real effective exchange rates, real estate prices, government debt ratio, private sector credit and its dynamics as a share of GDP, etc (see Buti and Larch, p.4)

Council. As some point out there is substantial vagueness in this regard (Giavazzi and Spaventa, Wiplosz).

Another issue is how would threatening “internal imbalances” be defined? For the scoreboard needs to get criteria on the basis of which judgments are to be made. Would markets discriminate among EMU member states in relation to their current account imbalances? Could a surplus economy be seen as being in violation of EMU stability when the latter is seen as a “public good”. Who would coordinate adjustment of imbalances in the EMU? How would Germany be judged in view of its heavy export orientation, outside the EU borders? How would non-eurozone member states be examined through the lenses of surveillance, for these economies are supposed to be net capital importers? Would the rules for dealing with “internal imbalances” apply to them as well<sup>17</sup>? And a bottom line: wouldn’t measures to limit “internal imbalances” contradict the free capital flow as a rule of the game in the EU?<sup>18</sup>

There would be major implications for national policies which are asked to undertake corrective measures. Governments could become more involved in the management of the economy, in mediating between social partners for the sake of achieving competitiveness targets. How realistic is it? It may be that the experience of Scandinavian countries, of Germany in undertaking reforms and making markets more flexible (while not undermining the social fabric of society) indicates the road ahead. But as competitive devaluation can be damaging the same could happen with wage controls, etc throughout the EU. Can EU policy guidelines help in this respect? Is Germany supposed to provide a benchmark for competitive policies in the EU? Answers are still to be given. It is noteworthy that Germany has introduced a balanced budget rule and France is contemplating one as well. This measure could put pressure on other EMU economies to do the same. Will they oblige?

### 2.1.3 Policy coordination: The economic semester

High hopes are pinned on “the economic semester”<sup>19</sup> for improving policy coordination and internalizing EU priorities in national budgets. In order to ensure that macro-financial stability issues are considered alongside macro-economic, fiscal and structural policies, the relevant communications from the European Systemic Risk Board (such as warnings and

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<sup>17</sup> A dangerous current account imbalance could be deemed as such when its financing is, principally, done via borrowing and, or speculative inflows.

<sup>18</sup> This is question raised by Dabrowski too ( p.2)

<sup>19</sup> This ex-ante coordination device was adopted by ECOFIN (The EU Council of finance ministers) on September 7 2010; it will cover policies to ensure fiscal discipline, macroeconomic stability, and to foster growth, in line with the Europe 2020 Strategy. “Existing processes – e.g. under the SGP and the Broad Economic Policy Guidelines – will be aligned in terms of timing while remaining legally separate. Stability and Convergence Programmes and National Reform Programmes will be submitted by Member States at the same time in the spring and assessed simultaneously by the European Commission” (The Task Force report, 2010)

recommendations) are to be taken into account. National budget frameworks will have to be constructed by addressing certain requirements: higher transparency and predictability; more reliable forecasting and effective multi-annual programming; the use of numerical rules in accordance with the SGP provisions; the functioning of independent bodies (fiscal councils) capable of providing thorough and honest assessment of government policies<sup>20</sup>.

Peer pressure and Commission and EU Council recommendations are supposed to help structure national budgets better, discipline national policy making. Nonetheless, it is questionable whether national priorities can be set by Brussels. Guidelines and constraints can be put forward, but how much would they count when it comes to deciding on the composition of public investment, of overall budget expenditure, is an open question. At the end of the day, national parliaments are sovereign. The heated debate on the size of the EU budget for 2011 would indicate what is in the offing in this respect. Therefore, a key aspect herein is how to increase national ownership of Commission and Council recommendations and bring national politicians (members of national parliaments) more in tune with the thinking in EU institutions.<sup>21</sup> Unless this is done an additional facet of the “democratic deficit” will arise, which is liable to cause new friction. To paraphrase “no taxation without representation: “no policy without representation” can endure.

For countries which are notorious for inadequate fiscal frameworks and weak local institutions, exogenous pushes would be helpful and should be welcome. Domestic fiscal rules and independent bodies (like fiscal councils) for checking how national policies are devised and implemented are also badly needed. These independent bodies need to be staffed with capable people (which implies that pay has to be adequate) and be given a status commensurate with their role. How would their independence and competence be secured depends also on by whom and how their senior management people are nominated.

## *2.2 Regulation and supervision of financial markets*

### *2.2.1 The reform of the regulation and supervision*

European policy-makers are pushing for an overhaul of the regulatory and supervisory structures of financial systems, including the parallel banking sector and rating agencies. Harmonization of

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<sup>20</sup> See also Council of the European Union (a)

<sup>21</sup>In order to enhance national ownership of the recommendations issued under the "European semester", governments, when submitting the draft budget to the national parliament are expected to include policy recommendations by the Council and / or the Commission accompanied by an explanation of how these have been incorporated

rules is not a sufficient response to the crisis, since the very content of regulations and supervision needs radical change. This is what comes out prominently from the de Larosiere report and the Turner report (in the UK), from documents of the European Parliament and directives of the European Commission. A reformed regulatory and supervisory framework would observe certain basic principles:

- all financial entities (including hedge funds and private equity funds) should be regulated and leverage be constrained;
- derivative markets should be regulated (products be standardized/simplified and clearing houses be used);
- remuneration be tied to long-term performance and be constrained;
- banks be better capitalized (both the amount and quality of capital, primarily of tier 1) and capital adequacy ratios set in light of systemic risks<sup>22</sup>;
- pro-cyclicality be avoided in macro-economic policymaking and the way banks modify their capital adequacy ratios;
- banks asked to hold equity shares of securitized loans;
- accounting rules should not fuel pro-cyclicality and be standardized globally;
- dealing with the “too big to fail” and “systemically important” entities: the splitting of big groups<sup>23</sup> and a return to a sort of Glass-Steagall<sup>24</sup> legislation are sensible options;
- regulatory arbitrage (including tax havens) be avoided;
- use of capital controls, where possible;
- limiting volatility in exchange rates and commodity markets (buffer stocks, curbing naked short-selling)<sup>25</sup>;
- the protection of consumers of financial services;
- transaction taxes as a means to help downsize an over-expanded financial sector, diminish negative externalities, and create fiscal revenues<sup>26</sup>.

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<sup>22</sup> The new form of Basel Accord (Basel III) would raise the tier 1 capital ratio to at least 7%.

<sup>23</sup> Market power (concentration) leads to market abuse and, in banking, as this crisis has glaringly proved, to heightened systemic risks by the formation of conglomerates which have engaged in the manufacturing of synthetic products, used high leverage and very risky investment strategies. Ironically, “the oligopolistic banking system that has emerged from this crisis is riskier than the one that went into it” (Wolf p. 9). Those who claim that size does not matter use a self-serving argument. The British authorities have already taken steps in this field by asking several banks to divest from some of their business components.

<sup>24</sup> However complicated such an undertaking would be it does make sense. ‘Casino-type’ banking has to be curtailed as much as possible and “proprietary trading” operations of banks be severely restrained.

<sup>25</sup> Measures have been initiated by EU commissioners Michel Barnier and Dacian Ciolos in order to restrict naked short-selling.

<sup>26</sup> There are two basic issues here: a/ systemic risk, which cannot be divorced from size and b/ allocation of resources and distribution of profits. The intake from such a tax would help the IFIs cope with effects of crises in emerging economies, poor economies in general. Proceeds from such a tax could help the EU set up a stabilization scheme for dealing with crises and could help fund the EU budget (commissioner Janusz Lewandowski has alluded to such a use)

In the EU there is need to strengthen the regulation and supervision of major financial groups, which operate cross-border. Hopefully, the ESRB (European Systemic Risk Board) and the new three authorities<sup>27</sup> (which will start to function from January 2011) will bring a decisive plus in this regard. The ESRB should intervene whenever credit expansion is threatening the stability of one or several of the EU member economies<sup>28</sup>. The G20 plans to regulate, more strictly, big banks, which have global operations, is a move in the right direction.

### 2.2.2 Financial stability in NMSs<sup>29</sup>

There are several means to enhance access to liquidity and mitigate solvency threats at a supra-national level; many of remedies have been implemented during the crisis: rules on convergence of deposit guarantees, which should prevent beggar your neighbour policies; medium-term financial facilities; IFIs credit lines and investments. Two avenues to improve the EU's support to NMSs deserve discussion: swap lines between the ECB and central banks of non-euro area countries; a broadening of ECB range of accepted collaterals to national currency denominated bonds issues by non-euro NMSs countries. These two measures, which would have helped to ward off euro liquidity shortages, were considered but not implemented at the height of the crisis. They should if conditions require them again.

Preventing credit booms will be an issue again in NMSs, sooner or later. Instruments that can be used are: counter-cyclical capital and reserve requirements; dynamic provisioning against expected losses; limits on leverage and maturity mismatches; discretionary macro-prudential measures under the guidance of newly created macro-prudential supervision bodies such as the European ESRB. The difficulty for the NMSs is that this toolbox mostly applies to countries where credit is in the hands of national banks or autonomous local subsidiaries of foreign banks. It is not likely to be effective in countries where credit is mostly in the hands of foreign bank branches or lending can be outsourced to foreign entities of the banking group (i.e. the parent bank or a subsidiary in another country). Coordination among supervisors can be a response and should continue being developed but calling for coordination is no solution when institutions participating in it have different, possibly conflicting mandates and incentives. This is where the role of the ESRB comes prominently into the picture. NMSs cannot rely on capital controls as the

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<sup>27</sup> The current EU Committees of supervisors (The Committee of European Securities Regulators (CESR), Committee of European Banking Supervisors (CEBS) and Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) would turn into European Supervisory Authorities (ESAs): a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). National supervisors should remain responsible for day-to-day supervision of individual firms. A steering committee of the ESAs should be set up to reinforce mutual understanding, cooperation and consistent supervisory approaches, in particular in relation to financial conglomerates, and to coordinate the necessary information sharing between the ESAs and the ESRB.

<sup>28</sup> This could involve applying differential minimum reserve requirements or by imposing anti-cyclical capital ratios (de Grauwe, a, p.5)

<sup>29</sup> This section draws on "Whither growth in central and eastern Europe" (2010)

single market prohibits such measures. Therefore, the risk of destabilizing capital inflows leading to credit bubbles has to be addressed through other means, which may include action on the demand for credit. Regulatory and tax instruments can for example be used to tame mortgage credit when deemed excessive from a macro-prudential point of view.

Since non-eurozone EU members states' financial markets are dominated by foreign groups, the home-country authorities have to work very closely with host-country authorities should a case of bank distress appear. It would be important for governors of the central banks (representing the main regulatory/supervisory bodies) in the region to keep in close contact and coordinate their measures.

### 2.2.2 Euro adoption

The crisis in the euro area shows that removing the option of adjusting a nominal exchange rate may be very costly in terms of fiscal adjustment if it is not accompanied by efforts to limit excessive demand in the private sector, even if fiscal policy is broadly in order. However, limiting excess demand in the private sector is not easy to achieve for national governments that have surrendered their power over monetary policy in an environment with free capital mobility. It is noteworthy that housing and credit booms in Ireland and Spain, and in several NMS have been quite similar, suggesting that the fall in real interest rates as the result of financial integration and economic catching-up matters both inside and outside the euro area. Euro outsiders should therefore be careful before fixing the exchange rate and should allow as much flexibility as possible on the way to euro adoption; they, in any case, should introduce measures preventing the emergence of unsustainable credit booms. But host country authorities may not be effective in this effort because of deep financial integration.

The crisis in the euro zone, in particular, the competitiveness problems of Spain, Portugal and Italy and the inability of these countries to adjust their competitiveness inside the euro area highlights a big policy issue: Should the criteria for the optimal currency area (OCA) be fulfilled *ex ante*, ie before a country enters the euro area, or is it sufficient to expect that they will be fulfilled *ex post*, ie euro admission will create structural changes in the economy that will make the country suitable to the monetary union, even if it had not been before? The inability of southern EMU countries to adjust to competitiveness pressures inside the eurozone suggests that it would be better for euro newcomers if OCA criteria are satisfied *ex ante* and there are policy instruments to guide the eventual need to adjust real exchange rate divergences *ex post*. The NMSs form a multi-coloured cluster; some of them are better integrated in EU industrial networks and show balanced trade accounts, while others (including Romania) have skewed trade imbalances and much of capital inflows went into non-tradeable sectors. Therefore, their chances of joining EMU are not similar.

A stumbling block for euro accession are the Maastricht criteria – which look more difficult to fulfill in view of the evolving European economic context (not to mention the Balassa-Samuelson effect in the case of catching-up economies). The EU could, in theory, adopt a more permissive approach towards NMS countries willing to adopt the Euro by relaxing/adapting the Maastricht criteria requirements. But allowing economies with a rather more “fragile” position to join the eurozone would weaken the Euro. Nevertheless, several NMSs are more liable to be fiscally sound, inside the Euroarea, than some older EMU member states. And if this is the case the menace of a weakening euro, because of an eastern enlargement of its area, loses some of its punch.

### 2.2.3 A mechanism for crisis resolution

The sovereign debt crisis in the euro area shows that the EMU policy framework is incomplete. EMU did not have policy tools to manage and resolve the crisis. After much delay the European Union agreed on assistance for Greece and created the European Financial Stability Facility (EFSF) for a three years period (until 2013). The ECB has called for the creation of a crisis management fund for the euro area, which would come into play if the strengthening of the rules-based framework does not suffice to prevent future debt crises. Such a fund should provide ‘last-resort financing’ at penalty rates to governments facing difficulties in accessing private credit markets. The European Council of 28-29 October 2010 stated that ‘Heads of State or Government agree on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area’<sup>30</sup>.

A recent report says that “The absence of any rules guiding market expectations about how governments and the Commission would respond to the crisis contributed to the volatility of financial markets during the crisis and this, in turn, contributed to the sense of urgency policymakers felt about the need to act”(Gianviti et.al.). The authors suggest the creation of a European Crisis Resolution Mechanism (ECRM) consisting of two pillars: A procedure to initiate and conduct negotiations between a sovereign debtor with unsustainable debt and its creditors leading to restructuring of its obligations in order to re-establish the sustainability of its public

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<sup>30</sup> A French-German agreement on 18 October talks about setting up a ‘permanent and robust framework to ensure orderly crisis management in the future’. German authorities are reported to be preparing a proposal for coordinating the demands of bond holders in a sovereign debt crisis and imposing ‘haircuts’ on the face value of the debt of a government in financial distress. The German position is revealed by finance minister Wolfgang Schäuble’s words: “it is worth remembering that monetary union was not intended to be a panacea for eurozone members, or for that matter a get-rich scheme for financial speculators. Nor was it meant to be a system of redistribution from richer to poorer countries via cheaper borrowing for governments by means of common Eurobonds or outright fiscal transfers. European Monetary Union won’t succeed if some countries persistently run deficits and weaken their competitiveness at the expense of the euro’s stability”(p.60). What this position underestimates, in my view, are implications of EMU’s sub-optimality and the need to use more effective tools in order to foster real convergence in this area.

finances. And rules for the provision of financial assistance to euro-area countries as an element in resolving the crisis. Should a euro-area country be found insolvent, the provision of financial aid should be conditional on the achievement of an agreement between the debtor and the creditors reestablishing solvency.

However, making the above mentioned proposal operational is not going to be easy. For instance, how to deal with the classic “free rider” problem that is the creditors who do not wish to participate in an orderly debt restructuring that implies “haircuts”. Are “collective action clauses” a sufficient instrument in this respect? There is also a view which says that the proposed sovereign debt default mechanism will make the EMU more prone to crises since it will introduce speculative dynamics into it, and an analogy is made with the Exchange Rate Mechanism (ERM) that preceded the start of the eurozone (de Grauwe, b, p.3). Because of such problems some see a European version of the IMF, as suggested by Gros and Mayer, as an alternative to a post-ESFF institution (Nielsen). There is even a train of thought which says that there is no need for a formal mechanism, that traditional tools, such as an exchange bond offer, would be sufficient (Roubini). But, high mutual exposure among financial entities in the EMU and powerful contagion effects would make individually triggered sovereign debt restructuring highly risky for both the country involved and the euro area. Moreover, as the experience with Greece and Ireland shows a country would hardly swallow its pride and declare, of its own volition, a moratorium on debt payments and ask for a restructuring. Another big problem can be that an inconsistent combination of “no bail out, no exit, no default” (as in the current EMU arrangements) would turn into another inconsistency, namely: the possibility of default, persistent imbalances and lack of proper fiscal arrangements (Munchau). This brings us back to square one, namely, the possibility of having a monetary union without a solid fiscal (budget) underpinning. Added to this is the need for real economic convergence in the EMU. Can Europe 2020 provide an effective tool to this end?

In the meantime, one wonders whether the fiscal adjustment programs, which are undertaken in several EMU countries, are all realistic; it appears that, in some cases a sovereign debt restructuring is unavoidable, in the end. This is more necessary since these programs are taking place in a pretty hostile external environment. Could EU policies play a role in bolstering the chances for these programs to be successful?

### *2.3 Dealing with global imbalances*

The current crisis has reinforced one of Keynes' intellectual legacies, which was enshrined in the Bretton Woods arrangements —namely, that highly volatile capital flows are inimical to trade

and growth and that financial markets are inherently unstable<sup>31</sup>. As a matter of fact restraining financial flows is a way to solve the *the impossible trinity*, which says that an autonomous monetary policy, stable exchange rate and free capital flows cannot be achieved concomitantly<sup>32</sup>. Therefore, if free trade and relative stability of exchange rates are to support durable economic growth capital flows need to be managed. The French government signalled its intention to enlist G20 in an effort to rethink and overhaul the architecture of the international financial system – which goes beyond redistribution of voting rights in the IFIs. The increasing number of emerging economies which resort to capital controls (in order to stem speculative flows) is quite telling about actual dynamics in the world economy. The IMF’s policy turnaround in this respect is also noteworthy.

### 3. Issues to ponder on

Disentangling private from public debt has become a huge, overwhelming issue in the EU in view of its deep financial integration. It is likely that the rescue program for Greece and Ireland were not least motivated, by the big exposure French, German and other European banks have to Greek and Irish sovereign debt. Private sector (bank) debts are making up enormous contingent liabilities on public debts when bankruptcies are not tolerated (not to mention the moral hazard problem). This is one of the big revelations entailed by the current crisis. And the inability to disentangle the myriad of intertwined debts will impact, negatively, on fiscal policies for years to come. Even now this feature of deep financial integration seems to be under-estimated by some. What is worrisome is that bank consolidation would preserve the hostage relationship governments budgets are held into. Ways must be found to make sure that a golden rule of market economy operates, namely, that investors bear the risks they assume and losses are not socialized.

The current crisis has refocused attention on public budgets owing to big jumps in their size, which were registered in countries where large financial entities were threatened by collapse and state intervention (rescues) occurred. But fiscal deficits are no less important in economies where the economic downturn has been significant and a permanent fall of potential output has, quite likely, ensued –where the crisis blew up bubbles and revealed years of resource misallocation. A country may have a relatively low public debt, but if its structural deficit is pretty high its debt service can skyrocket. Unless fiscal consolidation is put into motion a solvency crisis looms at the horizon. Related to this issue is the relevance of economic indicators. Fiscal deficits may be low for a while, until they explode when “hidden” imbalances come into the open. In the

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<sup>31</sup> For John Maynard Keynes’ contribution to the debate on the Bretton Woods arrangements see also Eichengreen. Skidelsky argues that it is high time to undertake a reform of the international monetary system and use some of Keynes’ ideas.

<sup>32</sup> This is shown, analytically, by the Mundell-Fleming model.

EMU, current account imbalances among member states were not paid attention until this crisis hit. Some use an analogy with the US which, arguably, is hardly relevant in view of very different fiscal arrangements.

Fiscal rules, surveillance and peer pressure may not be enough for strengthening the cohesion of the EMU, of the EU in general. A handicap in the EU is linked with the political reality that taxpayers are, ultimately, national citizens. Can “common goods” (including the euro) be protected unless “common resources” (the EU budget?) are more substantial? Can resolution schemes and orderly restructuring schemes of sovereign debts be devised so that they compensate the smallness of the EU budget and complexity of the EU decision making process? Can the EU policy-makers use additional instruments in order to foster more real convergence in the EMU, in the EU as a whole? Is there room for strengthening policies at EU level?

Would a deflationary bias in the conduct of monetary policy appear in view of the willingness to prick bubbles in their infancy? On the other hand, would’ n’ it, by fostering less instability, support long-term growth? This is also an issue which demands more thorough answers. In a way, answering this question is analogous to deciding on a proper speed of implementing Basel III: for a too fast implementation could stifle recovery; on the other hand, a too slow implementation would create prerequisites for a new crisis.

Debt deflation is a policy risk, though less in the EU than in the US. If this occurs in several major economies a relapse into a financial crisis would ensue, with staggering effects. A “Japanization” of these economies, namely a long period of stagnation induced by liquidity trap and low consumption, would take place. Financial stability would be once more at the top of public agenda in view of the steadily worsening bank balance-sheets. Public debts would be additionally burdened provided an exit via deliberate creation of inflation is considered not an option. And intense contagion effects would also be at work.

Does size matter for judging fiscal risk? It appears it does. Large economies are, seemingly, considered to have a bigger capacity to resist shocks; they are, potentially, more resilient. Resilience (ability to withstand external and internal shocks) will increasingly be a principal policy aim in the years to come.

What would be the impact of new technology for circumventing rules (ex: high-frequency trading)? Regulators and supervisors need to take it into account as well, when thinking about financial stability. The latter can be linked also with the capacity of economy to withstand effects of natural disasters, with social strain. Demographics, too, plays in a role when it perturbs inter-generational balance and, consequently, fiscal equilibrium.

The years to come will quite likely be accompanied by an increasingly uncertain environment; complexity will also be on the rise. These circumstances advocate a more simple, resilient financial intermediation system, for the sake of its own stability. If this does not happen and

global imbalances persist, more fragmentation is to be expected, with societies turning, probably, more inward-looking. This will have profound implications for the global system. It may be that, in view of the lessons of financial crises and of the need to lend to economies more resilience, there is an optimal size of openness (trade and finance-wise). This implies that firms need to think globally and operate selectively as a means for mitigating risks. It may also be the case that we will end up with a three blocs-based financial system as a means to maintain a relatively open global system (Daianu, 2009, 2010).

### **Final remarks**

This paper puts emphasis on *structure* and *networks* in understanding the roots of the current crisis and the tension in the EU (EMU). Such a perspective reinforces the rationale for a reform of the EU economic governance. As this crisis indicates it is not only fiscal rules and their compliance with that a proper functioning of the EMU hinges on. Flaws of financial intermediation, growing imbalances stemming from the dynamics of private sector saving and investment flows, inadequate regulation and supervision of financial markets, have played a major role in triggering the sovereign debt crisis in the EMU. The overexpansion of financial institutions and their investment behavior are to be highlighted as well. Consequently, a reform of the EU economic governance has to deal with fiscal rules and compliance, macroeconomic disequilibria and competitiveness gaps, the regulation and supervision of financial markets. The need to tackle global imbalances and overhaul international arrangements is to be mentioned in this context. Fostering real economic convergence remains a major issue in the EMU. Therefore, the EU institutions need to address this issue more thoroughly. A threat for the EMU is a growing cleavage between its northern tier and its southern tier, with the latter becoming, possibly, mired into vicious circles, incapable of overcoming the impact of fiscal consolidation in a hostile external environment. Another chasm could be deepened between older EU member states and several NMSs. Can Europe 2020 provide a light in this regard? NMSs have a deep stake in EU governance reform since they cannot escape the impact of EU wide externalities and the functioning of their economies depends on the rules of the Union.

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