

“The Global Economy in a Time of Uncertainty: Capitalist trajectories and progressive alternatives”

Conference organised by Ideas, Muttukadu, India, January 24-26, 2012

Panel on “Can the euro hold?”

A proposal for a Growth and Fiscal Compact

Mario Tonveronachi

University of Siena, Italy

Background paper, provisional draft

1. Many people think that a United Europe is about the creation of the single market. This happens not just outside Europe, but also in countries, such as the UK, that pertain to the European Union (EU). We had to be remembered by the Prime Minister of Poland, a recent entrant into the Union, that the long and tiresome process leading to the EU was borne to ensure European citizens peace, freedom and democracy. After hundreds of years of internal wars and millions of deaths, of tyrannies playing on nationalism and division, we tried to build a different, united Europe. The single market and the common currency are only means to the wider project.

We are now facing the most serious threat to this construction. National egoisms and division are reappearing because of the uneven costs produced by the current crisis. We left the European construction to become a technocratic superstructure, with no real democratic accountability. National interests impeded significant shifts of sovereignty to EU democratic co-operative decisions. Each forward step was made up of grandiloquent declarations more than the building of resilient and consistent EU institutions.

2. The birth of the euro at the end of the 1990s is a case in point. Since the start, the euro project was widely criticised for being largely inconsistent with the theoretical conditions required by an optimal currency area. The internal market was far from being a single market. While for some instances a rapid progress in that direction could have been possible, for others, as for the labour market, no medium-term solution was at hand. The principles of complementarity and proportionality, which the EU legislation must respect, mean that the legal framework finally remains largely national. Adding a common currency but not a federal fiscal authority to these heterogeneities was seen as a dangerous half-baked construction, leading to the build-up of internal

fragilities. With fiscal powers firmly in the hands of the member countries, the construction was considered not much different from (n-1) irrevocable national currency boards pegged to Germany.

The reference to the theory of the optimal currency area must be taken with a pinch of salt. As the same Mundell made it clear, in the real world no currency area is an optimal one. A sustainable, not optimal, currency area crucially depends on its institutional set up. Experience shows that national and federal models, in their numerous varieties, are viable constructions. Although they have not produced the disappearance of some sort of internal North-South divide, rarely the latter have posed systemic risks to the political construction. The Euro advocates thought that a third way was possible.

The euro model rests on adding two pillars, pre-entry convergence and post-entry consistency, to the maintenance of large, although decreasing, doses of national sovereignty. The accompanying institutional set up should help to enforce both. Instead of resembling a large jumbo jet, the EU-euro design looks like the duck flight, where it is possible to cover very large distances only flying in a precise, tight formation. Once admitted into the group, each duck retains its own identity, but it is constrained to follow a precise geometry. The sustainability of the design crucially depends on the set of rules governing the two pillars and on their enforcement. The possible original sins of the EMU construction should be sought more in rules and their enforcement than in the general design, which for many aspects is more demanding and rigid than the alternative models.

The pre-entry rules are based on the convergence of a set of variables - rate of inflation, interest rate, exchange rate, public deficit and debt – that are not univocal and comprehensive symptoms of eventual structural divergences. The post-entry rules, enshrined in the Stability and Growth Pact (SGP) and focused on public budgets, are a further subset with even weaker relations with maintaining or deepening the convergence process. This is not to say that official documents do not mention for both pillars some more general principles. Dissociating principles from rules means, however, that it was up to each single country to adopt a wider set of policies consistent with the common general vision and euro area sustainability. The room for moral hazard was then wide open. The illusion was that the non-bailout clause inserted into the Maastricht Treaty and the narrow focus imposed to the ECB (on these more later on) would have represented sufficient incentives for disciplining the member countries. The opposite was true: the initial success of the euro produced by itself moral hazard. The euro area countries experienced post-entry divergences in basic structural indicators (European Commission, 2011). Several countries lost competitiveness, in some cases masking serious imbalances with high non-sustainable growth. For the generality of the EU member countries, non-fiscal imbalances and fragilities, especially in the financial sector, were ignored. As for the specific rules concerning the two pillars, the result was not any better, starting from allowing entry to non-complying countries such as Italy, up to the minuet danced by Germany

and France in the mid-2000s, when reciprocally pardoning the breaking of the SGP rule on public deficit.

The first diagnosis is then one of insufficient or wrong rules and lack of enforcement.

In the EU space, rules and enforcement are the result of political compromises, both among national interests and alternative visions on the future of Europe. Political compromises are not the best friends of institutional efficacy and structural consistency. This is especially damaging for a design that keeps structural heterogeneities and national sovereignties living together with commonalities, like the euro. When, starting from heterogeneities and unresolved imbalances, few fiscal common rules effectively constrain the adoption of national policies that could render them effective in the medium-run by making systems converge, we have wrong rules. If for this or less noble reasons, the rules are not rigidly enforced but convergence policies too are not enforced, imbalances and fragilities accumulate. The lack of enforcement of a correct set of rules may be as damaging for the entire construction as the enforcement of a wrong set of rules.

The cohabitation of the EU and the euro area may shed some further light on the inconsistencies coming from political compromises. The language of the European Treaties is in terms of deeper integration, with the common currency being a necessary complement of the single market. The EU member countries should then orient their policies to reach the conditions consistent with adopting the euro. At the same time, however, the UK and Denmark obtained to opt out indefinitely from joining the euro area. To lessen the effects of the recent crisis, the UK could then adopt an aggressive devaluation policy while continuing to benefit from the single market. It was a rather non-cooperative attitude from an EU member country that was one of the main centres of financial infection. More recently, the UK has posed a veto on a proposal to reform the EU Treaties for deepening fiscal convergence, a decision consistent with its long-dated efforts against a more integrated Europe. The UK representatives normally look at each EU decision in terms of narrow British interests: understandable, but hardly consistent with pertaining to an exclusive club, not to say to a political union. If the club decides to end its gender discrimination for membership, dissenting members should not expect to be entitled to have a separate male room paid for by common funding.

Another relevant aspect is the relation between the ECB and the European financial system, or, rather, the banking systems of the euro area countries. There are few doubts that a common monetary policy requires national financial systems subject to common rules and supervisory practices. While the Maastricht Treaty leaves open for the ECB to assume the role of banking supervisor, national authorities were left in charge. Irrespective of our opinion on making the current regulatory and supervisory approach the homogenous framework for the EU countries, the reasons behind that solution were not those of making banks more resilient or the transmission of monetary

policy more fluid. The supervisory failures exposed by the recent crisis and the data on banks' capital composition and average risk weights show how national practices differ on complying with supposedly common principles and rules. Let us take the case of Germany. German authorities left their banking system survive with a dismal structural profitability by allowing strong proportions of hybrid capital, low risk weights and high leverage in front of strong doses of toxic assets. The result is that, according to the Basel criteria, German banks generally appear to be better capitalised than banks pertaining to jurisdictions that follow more stringent supervisory practices. Taking at face value the data coming from banks, not always certified by national supervisors, for its recent 'EU capital exercise', the European Banking Authority (EBA) has put its seal to existing practices. Investors seem to be content with this result, and funds from troubled countries are channelled, *inter alia*, to Germany and German banks, adding difficulties to the ECB and the European payment system. This is just an example of a more general problem. Independently of what causes capture, we observe again how national aversion to shifts of sovereignty produced relevant inconsistencies and fragilities.

EU Treaties, Directives, Regulations and official documents assert that the main goals of the EU and national policies should be employment and growth. Monetary and financial stability and fiscal discipline are preconditions to attain those final objectives. Unfortunately, the conservative political approach that sees with suspect government intervention in economic matters has gained momentum. Apart from few specific cases, the current situation is, on the contrary, the product of inaction rather than wrong actions. The financial crisis has been the result of letting financial markets rule the game. The loss of competitiveness troubling some EU countries is due to the lack of public policies, in particular to dismantle rent positions. The dynamics of public expenditure surpassing that of GDP for the generality of EU countries often comes from letting the automatic pilot go, while fast changing economies require structural interventions on public revenue and expenditure. The problem is not politics, but too often bad politicians. The cure is not to restrict the scope of government action and give markets a free hand, but to strengthen democratic accountability, especially at the EU level.

In short, under many profiles the European problem is primarily a political one. If we want to give it a touch of *noblesse*, we can trace it back to differences on principles and perspectives. In any case, the severity of the current crisis shows that it is time to clear the fundamentals of the EU construction, not just of the euro area, and the consistent direction we want to impress to it.

3. Although some steps towards a more representative and efficient European economic governance were taken before the eruption of the current crisis (e.g. the Treaty of Lisbon) and some reforms were swiftly adopted, a serious discussion on the profound revision of institutions and rules

have been forced by the recent sovereign crisis in the euro area. Consequently, political and policy divisions have become even more evident.

Let us for the moment put on one side the short-term policy responses needed to avoid the breaking up of the Union, and focus on the long-term reforms necessary to give the European citizens and foreign investors the perspective of a viable construction. Confidence in this strategic perspective is crucial for the effectiveness of any set of short-term policies.

A preliminary question is whether the most sensible solution would be that of freeing the euro area from the 'peripheral' countries, or some of them, thus reaching the lower heterogeneity required for the viability of a currency area. Apart from the costs of the operation, nothing precludes that in the future the same problems may reappear inside the purged area. A deep reform of the economic governance would anyway be necessary. Furthermore, it is quite certain that the entire EU construction would be profoundly revised if not abandoned, with the single market as the main loss.

Since the long-term balance of costs and benefits of the break-up solution appears to many to be clearly on the negative, even forgetting why in the first instance we wanted a united Europe, the discussion shifts to reforms encompassing all existing member countries, a point on which all governments seem to agree. The 'reformers' have obviously the onus to show the long-term viability of the proposed framework. Let us then analyse the recent reforms of the EU economic governance following three steps: the decisions process, the set of rules, and their enforcement.

The recent implementation of the Treaty of Lisbon made the decision process even more baroque. Seven institutions govern the EU (for some more details see the Annex). The supreme organ for dictating the political and policy agenda is the European Council (EC), which consists of the Heads of State or Government of the member states, and which acquired the formal status of institution with the Treaty of Lisbon. The EU legislation comes from the Council of the European Union (Council or Council of Ministers), composed by ministers of the EU governments, for many matters in co-decision with the European Parliament, the only directly elected EU institution. The European Commission (Commission) is the executive body, which is normally empowered with drafting proposals for Directives and Regulations.

The remaining three EU institutions, not touched by the reform, are the European Central Bank, the Court of justice (which upholds the rule of European law) and the Court of Auditors (which checks the financing of the EU's activities).

The strength of the interaction between the financial sector and public finances highlighted by the crisis has also promoted an institutional reform in the financial regulatory and supervisory fields. Three new independent European Supervisory Authorities (ESAs) have replaced, with extended powers, three Committees previously operating under the Commission's prerogatives. Basically, EBA, EIOPA and ESMA must produce single rulebooks respectively for the banking, insurance and

market sectors, and coordinate national supervisory practices. The Regulations that created the ESAs clearly affirm that the goal is to restrict national discretion and promote homogeneous supervisory practices, consistently shifting the production of laws from Directives (based on principles that must translate into national laws according to local specificities) to Regulations (directly applied at national level). In addition, a European Systemic Risk Board (ESRB), whose governance is dominated by the ECB and national central banks, is entitled with macro-prudential supervision. While the ESRB may only produce recommendations, the legislative proposals coming from the ESAs become laws by co-decisions of the Council and the Parliament, after the filter of the Commission, which can approve or reject them but not change their content. As far as regulation is concerned, we may expect that the single rulebooks will produce a significant shift from the existing minimum harmonisation to maximum harmonisation, an interpretation, however, currently resisted by the UK. Unfortunately, supervisory practices will largely remain outside the direct reach of the ESAs, and their limited access to information and weak enforcement powers will hardly render them able to intervene in the many details in which the national devils lie. The reform is a step forward, but, despite the intentions, it is short of building an institutional setting capable of ensuring homogeneous supervisory practices.¹

The institutionalisation of the EC at the helm of the decision process may be read in different ways. On the one hand, it gives to EU decisions a more marked political representation; on the other hand, it makes decisions the result of national political compromises more than of the interests of Europe as a whole (as on the contrary the Commission likes to represent its own approach). Worryingly, the frequent changes of majorities in national governments in an area of 27 countries could slow down the decision process and render decisions more volatile.² This explains why current discussions fundamentally centre on the room that the EU Treaties should leave to EC deliberations.

We can single out three countries, the UK, France and Germany, for their economic relevance, but mainly because their position towards EU affairs appears to be less sensitive to changes in political majority. As its multiple opt-outs show (euro, Schengen, social and employment policies), the UK is only interested in the single market and opposes Treaty changes directed at shifting portions of national sovereignty to the EU. It has not changed its centuries old European policy of *divide et impera*, having favoured the EU enlargement as a way to stop integration by increasing heterogeneity, while trying to organise a fifth column inside the EU for matters in which its opt-outs make itself less directly relevant. Despite its strong national roots, France favours EU integration, although in forms that leave the more powerful countries in command. Contrary to the UK, France

¹ This is confirmed by two 2011 initiatives from EBA, stress tests and capital exercise, that have relied on banks' information that should have been validated by national supervisors.

² The partial rebalancing in favour of the, up to now irrelevant, Parliament in the co-decision process does not appear capable of changing the result.

openly asserts the strategic role of the State in economic matters, thus favouring a wider scope of action for politics than for rules. It sees favourably a two-speed Europe, as a way to lessen the too market-friendly approach of the UK. The framework created by the Treaty of Lisbon, with frequent EC meetings giving political inputs to the other EU institutions, well represents its approach. In the discussions of new reforms, France tends to oppose the introduction of new, too rigid and stringent rules, and considers too strict the rules governing the ECB. Germany is a bit more market-friendly than France is, and distrusts giving politicians, also its own, too large discretionary powers. Germany thus favours rules designed to contain within strict limits both EC decisions and national discretion. Less fond of the power of moral suasion and multilateral surveillance, it also wants rules designed to improve enforcement. Although Germany is in principle contrary to a two-speed Europe, the profound redesign it purports implies a revision of the Treaties governing the mutual relations among the EU countries; a revision looked at with suspect by the UK as leading to higher integration.

4. The EU Treaties, now consolidated in the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU) (OJEU, 30.3.2010, C 83), are the highest sources of the rules governing the Union.

For what concerns the present argument, the TFEU includes three main rules. The first is the non-bail out clause that forbids Union financial assistance unless a member state “is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control” (TFEU, art. 122.2). Since the clause excludes difficulties that would have been avoided by the adoption of prudent policies, it encompasses all recent crisis events. The second rule obliges member states to contain their deficit and debt within reference levels, whose specification of 3% for deficit and 60% for debt is contained in an annexed Protocol. Non-complying countries are submitted to excessive deficit procedures, leading the Council to take increasingly punitive measures, up to impose fines. Worth to note, the evaluation of excessive deficit must take into account “whether the government deficit exceeds government investment expenditure”, whether it results from exceptional and temporary circumstances, and if appropriate measures are taken to go back to the reference values (TFEU, art. 126.3). Furthermore, the TFEU and the Protocol do not mention time limit within which a country must eliminate the excessive deficit or debt. The third rule concerns the ECB, which cannot buy sovereign debt in the primary market, leaving open its intervention in the secondary market. As ECB officials have repeatedly affirmed, the letter and spirit of the rule admit intervention in sovereign debt as far as it is necessary to ensure the transmission of monetary policy. Finally, while the fiscal rule applies to all EU countries, being their reference levels specified in a Protocol signed by all EU member states, it is possible for the subset of the euro area countries to agree on levels that are more stringent.

Some other features of the Treaties must be underlined.

The EU legislation must respect the principle of subsidiarity, according to which the EU may step in only when the pursuit of the goals contained in the Treaties, made more specific by EC decisions, cannot be effectively achieved at national level. In this case, however, it must also follow the principle of proportionality, calibrating the intervention to what is just needed. Legislation based on minimum harmonisation derive from these principles. The ample discretion left in the application of these principles submits the legislative process to lengthy negotiations and disputes. For example, the decision to keep national authorities to command financial supervision may be justified by those principles; on the other hand, the case for interpreting the single financial rulebooks (see above) as maximum harmonisation has been strengthened by the reference to the recent crisis. In other terms, also within the limits posed by the Treaties there is room for significant shifts of sovereignty to and from EU institutions.

The Treaties also contain insidious ambivalences. They state that all the EU countries will in due time join the monetary union, being a means to enhance the stability and growth perspective of the whole area. At the same time, Protocols 15 and 16 grant to the UK and Denmark an indefinite opt-out from adopting the euro, *de facto* sanctioning the birth of a two-speed, or two-layered Europe. Allowing opt-outs to accumulate, as we have seen for the UK, beggar-thy-neighbour policies may ensue putting the very idea of the currency union and single market in jeopardy. Less dramatically, the existence of two different perspectives makes the legislation process of the EU much more complicated.

Finally, experience shows that the revision process of the Treaties is a very difficult and lengthy process, whose final approval by all member states is in no way assured.

Summing up, the Treaties pose limits to the action of EU institutions, particularly binding for the use of EU and ECB funds to bail out sovereign debt. In order to overcome these legal limits a revision of the Treaties would be necessary, being anyway a too lengthy process to deal with the immediate threats prompted by the current crisis. To use these threats to justify the rupture of the legal framework would lead to destroy the Union in the same way as leaving the crisis to unfold with no incisive intervention. This means that the current sovereign-financial crisis must be dealt with ingenuity inside the room of manoeuvre left by the existing EU Treaties.

This does not dispense from designing a viable perspective for the economic governance. As already argued, this is on the contrary a necessary condition to give credibility to short-term interventions. However, we cannot expect big institutional changes to be planned in the near future. First, the economies of the member countries, even across the subset of the Euro Area, are still too heterogeneous as regards their legal and structural features to make some meaningful form of federal arrangement possible. Second, having the current crisis magnified national oppositions to a

'transfer Union', the political convergence to the federal path is in no way granted. Practicable solutions rest on gradually deepening the convergence process inside the recently adopted Lisbon institutional framework.

We are then back at reconciling the three views that we have simplified as stemming from Germany, France and the UK. A necessary precondition is to agree on giving an end-date to the opt-out system, hence to the two-layer Europe. Given the existence of the European Economic Area (EEA), a loose association of countries to the EU, the choice must be to pertain to the EU or to be a member of the EEA. The Treaty of Lisbon introduces the possibility to leave the EU. Countries that decide to remain inside the EU must have clear the necessity of increasing convergence, hence of gradual but inevitable shifts of sovereignty from national to EU institutions, the common currency included. This would be, per se, a relevant item in the clarification of the direction to impress to the EU-euro area construction. The other open question is how much the convergence process must rely on political discretion or rules. To be credible, some clear-cut solutions must be offered with respect to the past. Germany has led the way towards the idea of ensuring a higher degree of enforcement to more stringent rules. Let us clear the way from a possible misunderstanding. The new economic governance is not thought as a way to deal directly with the current crisis. It is part of a medium-term solution thought for giving viability and credibility to the EU-euro area construction.

5. The Council and the Parliament recently approved a set of new Regulations, the so-called six-pack. They reinforce the existing preventive and corrective actions for fiscal policies and introduce surveillance on macroeconomic and competitiveness imbalances. The Commission will have a stronger role in the enhanced surveillance procedures.

For fiscal sustainability, the reference is a country-specific medium-term budgetary objective (MTO) that "may diverge from close to balance or in surplus position, while providing a safety margin with respect to the 3% of GDP government deficit ratio". The MTO should "allow room for budgetary manoeuvre, considering in particular the need for public investment." For member states of the euro area the MTO "shall be specified within a defined range between -1% of GDP and balance or surplus, in cyclically adjusted terms" (Regulation 1175, art. 2a). While converging towards its MTO, a country may have to limit the rate of increase of public expenditure. The excessive deficit procedure (EDP) can now result from excessive debt as well as deficit. Countries with debt higher than 60% of GDP must annually reduce it according to a numerical benchmark.³ A non-interest bearing deposit of 0.2% of GDP is imposed on non-compliant euro-area countries; failing to comply with recommendations for corrective action the deposit will be converted into a fine.

³ According the *Conclusions* of the meeting of the Heads of State or Government of the Euro Area of 11 March 2011, for the euro area countries the numerical benchmark should be 1/20.

Having member countries experienced in the last decade competitiveness divergences and macroeconomic imbalances within the EU, a new surveillance mechanism is introduced. The alert system will be based on a scoreboard of macroeconomic and macrofinancial indicators and specific country studies. When an Excessive Imbalance Procedure (EIP) is decided, policy recommendations are formally communicated to the interested country, which should adopt correcting actions. “[P]olicy action is particularly pressing in Member States showing persistently large current-account deficits and competitiveness losses. Furthermore, in Member States that accumulate large current-account surpluses, policies should aim to identify and implement measures that help strengthen their domestic demand and growth potential.” (Regulation 1176, point 17) Failing to comply, euro-area countries should be subject to financial fines, starting from a non-interest bearing deposit equal to 1% of GDP, which may be finally converted into a fine.

Furthermore, “[e]nforcement is strengthened by the expanded use of ‘reverse qualified majority’ voting. Under this voting system, a Commission recommendation or proposal to the Council is considered adopted unless a qualified majority of Member States vote against it” (ECFIN, *EU economic governance*, 23/12/2011, p. 1). In other terms, the start of an EIP becomes more automatic.

The European semester represents a relevant piece of the new economic governance. The year is divided in two semesters. The first, the ‘European semester’, begins with the “Commission’s Annual Growth Survey, which gives broad guidance on priority actions to be taken at EU and national level. Member States then submit Stability [if euro area countries] or Convergence [if non-euro area countries] Programmes on their fiscal plans and National Reform Programmes on structural reforms and measures to boost growth and jobs.” (ECFIN, *EU economic governance*, 23/12/2011, p. 2) The programmes should be the result of consultations and discussions of governments with their relevant national stakeholders, the parliament in the first instance, to ensure ‘national ownership’. Under the coordination of the Commission, EU-level discussions on “fiscal policy, macroeconomic imbalances, financial sector issues, and growth enhancing structural reforms” then follow (Ibid.). As we have seen, the discussions on macroeconomic imbalances will be based on a specific set of new indicators (scoreboard). “The Commission assesses these reports based on an integrated analysis ... and on that basis proposes policy recommendations for each country. The June European Council discusses the recommendations and the Council adopts them.” (Ibid.) In the second semester, the ‘national semester’, each government submits its draft budget to the national parliamentary debate for approval. The Commission monitors the compliance of national programmes with the decisions taken at the Council-level.

Despite countries being held up to public scorn and subject to sanctions, the EU economic governance would continue to rely mostly on moral suasion and multilateral surveillance. Besides the stricter conditions imposed to the euro-area countries, the two-layer Europe also shows itself in

the absence of the specification of financial fines for non-complying non-euro countries. Given the single market, this is a particularly relevant point when macroeconomic imbalances accumulate.

Since Germany was not expecting much from the new economic governance coming from the six-pack legislation, it pushed for writing fiscal enforcement at national maximum, constitutional level.

The 2011 December Summit of the European Council signed an important step in that direction when most EU countries agreed on a new “Fiscal Compact”. Due to the opposition of the UK to change the EU Treaties, by March 2012 the new rule will be enshrined into an intergovernmental treaty, which perhaps will also be signed by most non-euro countries. The main elements of the rule will be: the general government budget shall be balanced or in surplus, with the annual structural deficit not exceeding 0.5% of GDP; the rule shall be introduced in national legal systems at constitutional or equivalent level and will contain an automatic correction mechanism; the rule will be defined by each member state on the basis of principles proposed by the Commission; member states will report ex ante on their debt issuance plans. (Statement by the Euro Area Heads of State or Government, Brussels, 9 December 2011). The document also asserts that the “specification of the debt criterion in terms of numerical benchmark for debt reduction (1/20 rule) for Member States with a government debt in excess of 60% needs to be enshrined in the new provision”. Finally, the Council and the Parliament should promptly examine two new Regulations proposed by the Commission for the euro area, strengthening the rules for excessive deficit procedures and the surveillance on member countries experiencing or threatened with serious difficulties.⁴

In return for the new fiscal compact, euro-area countries have anticipated to July 2012 the operation of the European Stability Mechanism (ESM), a permanent fund based on an intergovernmental treaty, with an initial maximum lending capacity of EUR 500,000 million. With the assignment to finance euro-countries with funding difficulties, the ESM will count on the cooperation of the Commission and the ECB to make its operations consistent with the EU multilateral surveillance framework. The fund should finance illiquid, not insolvent positions. The latter could tap ESM funds only after a restructuring agreement with private creditors capable of putting the debt on a sustainable path. Worth to note is that countries seeking funds from the ESM will have also to apply to the IMF, meaning that the Commission-ECB-IMF troika will follow the general rules of the IMF, conditionalities and costs included.⁵

Another product of the fiscal agreement is a free hand given to the ECB to finance banks. The European banks, especially the bigger ones, have three major problems. A high proportion of their assets consists of underperforming sovereign bonds and loans, high leverage and excessive

⁴ *Inter alia*, the Commission proposes that national stability and reform programmes should be based on “independent macroeconomic forecasts”, and that each country should have an “independent fiscal council” in charge of monitoring the implementation of fiscal rules.

⁵ The future treaty on the fiscal compact should also contain a revision of the treaty on the ESM.

exposure to wholesale funding. They are currently experiencing the classical interaction between funding and market risks, with a relevant currency problem due to the drying up of funding in US dollars in front of large exposures in US assets (Shin 2011). The ECB, with the help of the Fed, has stepped in practically substituting wholesale depositors and bond investors, and substantially ready to become in the next years the second relevant source of bank funding, after retail depositors. The official explanation is that the intervention is necessary to avoid a credit crunch, while in reality is to avoid a major systemic banking crisis. This 'non-standard' intervention goes against the iron approach of the Bundersbank, since the volume of the intervention surpasses what can be sterilised, and because some German banks are benefiting from funds running away from euro area troubled countries. In addition, to make the manoeuvre effective the ECB has considerably lowered both the quality of assets acceptable as collateral and the funding cost. In this way the ECB creates a significant moral hazard problem since it may 'unwillingly' bail out troubled banks. It is my opinion that the, otherwise inexplicable, harsh capital exercise performed by the EBA has been required by the European Council to soften this type of criticism.⁶

6. Inserting into national constitutions extremely strict margins for deficit, the reference to structural balanced budget that however measured may be questionable, and automatic corrections will produce more problems that it is intended to solve. Perhaps it would be simpler, although not necessarily more appropriate, to write into a constitution that, apart from wars and national disaster, public debt cannot stay higher than a certain percentage of GDP for more than, say, five years.

If national constitutions must be reformed, it should be by explicitly recognising the force of the EU Treaties and the necessity to incorporate, swiftly and timely, EU secondary legislation into national laws and government action. If enforcement must be strengthened is in the above direction. Many European politicians present the new fiscal compact as a strategic step towards a stricter political union. Imposing to each country to enforce on its own fiscal discipline is, on the contrary, a relevant loss of the EU role.⁷ We may ask why it would not suffice the write the new fiscal rule into an EU

⁶ The EBA 'exercise' for major EU banks is based on a minimum Core Tier 1 requirements of 9% of risk-weighted assets, with government bonds marked at September 2011 market prices. Given the existing rules, unfavourable to traditional banking and open to heterogeneous national supervisory practices, unsurprisingly banks of the GIIPS countries show the highest average risk-weight and are in the forefront for the recapitalisation.

⁷ Those who lament a gap in the democratic representation in the EU institutions should remember that strategic decisions are taken by the EC, the Council and the Parliament, whose members are the result of national democratic processes. Recent proposals suggest to give a European super minister the power to intervene in national fiscal decision (Trichet, 2011) and raise revenues (Marzinotto et al, 2011), eventually as part of a reform for the direct election of EU government (Goodhart et al, 2011). These are useful contributions to the discussion on where finally to land, but appear to be too far from what presently political convergences may attain. In reality, the problem lies in accepting the loss of national sovereignty coming from decisions taken at the EU level with majority voting. Once this is made crystal clear in the constitutions and to voters, we may expect a demand for accountability of EU decisions not much different from what would result

Regulation. Here the political point: since EU Regulations are easy to amend, Germany *et al* are not sure to maintain in the future a majority favourable to a severe fiscal discipline.

However, apart from procedural problems, leaving actions in favour of growth with much lower enforcement, the fiscal compact greatly increases the already strong EU bent towards a structural fiscal deflationary stance. Furthermore, it does not go the roots of the problem, which is not sovereign debt *per se*, but structural divergences among the euro area countries. Thought as being the stable institutional solution, not the way to lower progressively existing sovereign debts under a certain proportion of GDP, this is simply nonsense.

If someone expected that the new fiscal compact would have convinced investors to relax, a bad signal is that the crisis is increasingly spreading across Europe. Unconventionally, industry analysts are often more worried about growth than European politicians and EU officials. With quite all EU countries' sovereign debt higher than 60% and taking seriously the application of the sum of the fiscal compact and the 1/20 rule, we must expect many years of fiscal austerity and low growth, or, worse, recessions, self-defeating fiscal objectives and the deepening of the financial crisis. Furthermore, the limited ammunitions given to the ESM are evidently insufficient to tackle what is now a systemic European crisis.⁸

Beyond social considerations, there are then many reasons to reformulate the economic governance and rules in order to give prominence to growth and employment, and to rethink in the same direction the short-term policies to tackle the crisis. The EU attention and action should focus on the growth objective of the European Semester's Reform Programmes. The attention to growth should not be limited to, and constrained by macroeconomic imbalances. A 'Growth Compact' should at least accompany a fiscal one.

Apart from its unintended consequences, the fiscal compact is the easiest political solution: one simple rule and few definitions. This makes it potentially simple to monitor and enforce. A growth compact would be much more complex, in particular for the definition of its objectives, active policies and remedial actions. However, with the Europe 2020 Strategy the EU has already adopted a manifesto with ambitious objectives for employment, innovation, education, social inclusion and climate/energy. Putting national Reform programmes and the Macroeconomic imbalances surveillance under the aegis of Europe 2020, we could aim at containing infra-Europe imbalances while promoting pro-growth mechanisms and policies. What is necessary in many cases is to exploit flexibilities and programmes that already exist. For instance, the recent EU regulation on macroeconomic imbalances hints at symmetric adjustments for deficit and surplus current account

from more direct forms of representation, which in the current circumstances might only add to language cacophony.

⁸ Net of existing obligations, the ESM lending capacity will be lower than the debt that just Italy must rollover in 2012.

positions (Regulation 1176/2011, point 17). The regulation on surveillance of budgetary positions includes several references for favourably considering government investment expenditure in the assessment of deficit positions in the stability programmes (Regulation 1175/2011, point 17 and articles 2a and 3b). EU flagship initiatives (e.g. for innovation, energy/environment and communications) could be better endowed and give preferential lanes to countries with competitiveness problems. Gradually, but with decision, the enormous portion of the EU budget now devolved to common agriculture policy could be oriented to help the EU structural and cohesion funds to enhance growth. EU countries already have what Minsky termed Big Government, i.e. a high proportion of public expenditure to GDP. For many of them the crucial question is to change the composition of public spending to favour systemic efficiency. Technically and for social reason, we should expect significant result only in the medium-term. Apart from the reallocation of existing funds, additional financial resources are necessary at EU and national level to make a growth compact effective. Raising additional funds to finance properly serious growth initiatives should represent a more credible signal for investors than focusing on self-defeating fiscal entrenchments.

However, two problems need particular attention: enforcement and funding.

In the current political and financial situation of Europe, it is clear that an equilibrium mix of growth and fiscal compacts must be found. To reassure fiscal hawks and investors, the growth compact should be utterly credible, not considered just a deficit spending programme. Fiscal discipline should require maximum efforts to mobilise existing resources and the efficient use of the new ones. This implies not only careful ex ante programming, but also strict surveillance and high enforcement power by EU institutions. Incentives and penalties should be designed to maximise the benefits of a strict adherence to growth programmes.

The problem of funding is linked in part to the credibility of the growth and fiscal compact, in part to the prolonged period necessary to obtain significant results. Longer the period, higher the difficulties regarding surveillance and enforcement and higher the amount of funds needed to meet the necessities for existing and new funding. We have seen that the euro countries agreed on creating the ESM to fund the necessities of illiquid governments. Some member countries and many analysts propose to increase the EUR 500,000 million of its lending capacity, considering that the additional EUR 200,000 million promised to the IMF, substantially for joint European operations, do not change much the situation. As things stand, i.e. with the only focus on the fiscal compact, they are right. Although an increase in the ESM's lending capacity might initially be necessary, shifting to the growth and fiscal compact would permit to limit that increase while creating a Growth European Mechanism to fund properly EU-level and national investments.

7. Summing up and concluding, the viability of the euro construction depends on the political and institutional framework of the entire European Union. The peculiarity of the Union with respect to traditional models is to keep together sovereign states by means of international treaties whose objective is to produce gradual political, social and economic homogenisation, consistency and convergence.

The current sovereign and financial crisis has reignited the debate on whether a common currency may exist without a central fiscal authority, i.e. without the autonomous power by EU authorities to raise taxes. In other terms, the EU should be able to match common monetary policies with an EU fiscal policy. As usual in federal arrangements, this would imply infra-Union tax transfers. In particular, a central fiscal authority is considered necessary to cope with EU wide crises.

I have argued that the homogenisation and converging path have not yet reached the stage where some significant form of federalism is possible. This obliges, now and in the near future, member states to match the common currency more with consistency than homogeneity.

The first ten years of the euro have shown both inconsistent policies and diverging economies, pointing to serious failures in the political and economic governance. Among discording voices, the focus of the lagged response of EU politics is on increasing the consistency of fiscal policies, neglecting to some extent their consequences in terms of convergence and social unrest. The new fiscal compact would actually eliminate national room for significant anti-cyclical policies, while we presently need both anti-cyclical and structural interventions.

With respect to the proposals asking for some form of federalism, they should explain for what types of policies it should be thought of. National divisions do not disappear just giving to an EU elected government power of intervention. A priority is the clarification of what the EU wants to be when of age. Furthermore, despite the *acquis communautaire*, national jurisdictions and legal practices remain so heterogeneous to render the enforcement of purely central decisions a constant nightmare. Before going to such new institutional innovations, we need to strengthen the convergence, first of the legal framework and its enforcement. This requires, *inter alia*, discarding the allowance of opt-outs.

If we have to accept the imposition of more consistent policies, this does not mean that we have to focus solely on the fiscal compact. As a long-term governance solution and the way to tackle the current crisis, the fiscal compact does not go the roots of the crisis, will be riddled with problems, and most probably will be self-defeating. Fiscal discipline should be directed to free existing resources and access new ones to enhance growth. A Growth and Fiscal Compact, accompanying the ESM with a Growth European Mechanism, appears as the current preferable approach to tackle current problems and to give a viable perspective to Europe. An even stricter enforcement framework must, however, be devised to give credibility to this design.

A pro-growth Europe is what we strongly and urgently need to contrast the re-emergence of European old vices, such as nationalism and populism.

Annex

The European Council (EC)

The EC “defines the general political direction and priorities of the European Union. With the entry into force of the Treaty of Lisbon on 1 December 2009, it became an institution. ... The European Council provides the Union with the necessary impetus for its development and defines the general political directions and priorities thereof. It does not exercise legislative functions. ... The European Council consists of the Heads of State or Government of the Member States, together with its President and the President of the Commission. ... Except where the Treaties provide otherwise, decisions of the European Council are taken by consensus. In some cases, it adopts decisions by unanimity or by qualified majority, depending on what the Treaty provides for.” (Excerpts from the EC web site)

The Council of the European Union (Council or Council of Ministers)

The Council plays a central role for the implementation of the general guidelines decided by the EC. “Acts which are directly relevant to the lives of EU citizens and have a considerable international impact are adopted by the Council, usually in conjunction with the European Parliament. ... The Council is the EU institution where the Member States' government representatives sit, i.e. the ministers of each Member State with responsibility for a given area. The composition and frequency of Council meetings vary depending on the issues dealt with. ... economics and finance ministers meet once a month in the Council which handles economic and financial affairs, called the Ecofin Council.” The Council “adopts legislative acts (Regulations, Directives, etc.), in many cases in ‘co-decision’ with the European Parliament; it helps coordinate Member States' policies, for example, in the economic field; it develops the common foreign and security policy, on the basis of strategic guidelines set by the European Council; it concludes international agreements on behalf of the Union; it adopts the Union's budget, together with the European Parliament.” (Excerpts from the Council web site)

The European Parliament

The Lisbon Treaty has upgraded the role of the European Parliament giving it “new law-making powers: it now decides on the vast majority of EU legislation. Over 40 new fields come under the

procedure for co-decision by Parliament and the Council of Ministers ... Parliament has the last say on the EU budget. With more power comes more responsibility. Parliament, as the only directly-elected EU institution, will have new means to keep the EU accountable to its citizens.” (Excerpts from the Parliament web site).

The European Commission (Commission)

The Commission “is the EU's executive body and represents the interests of Europe as a whole (as opposed to the interests of individual countries). The Commission's main roles are to: set objectives and priorities for action; propose legislation to Parliament and Council; manage and implement EU policies and the budget; enforce European Law (jointly with the Court of Justice); represent the EU outside Europe (negotiating trade agreements between the EU and other countries, etc.).” (Excerpts from the Commission web site)

References

- European Commission (2011), *Annual Growth Survey 2012*, Brussels, COM(2011)815.
- Goodhart C.A.E., Schoenmaker D. (2011), “The political endgame for the euro crisis”, VOX EU, 14 December.
- Marzinotto B., Sapir A., Wolff G. (2011), “What kind of Fiscal Union?”, Bruegel Policy Brief, 2011/06, November.
- Shin H.S. (2011), “Global banking glut and loan risk premium”, paper presented at the 12th Jacques Polak Annual Research Conference hosted by the IMF, Washington DC, November 10-11.
- Trichet J.C. (2011), “Building Europe, building institutions”, speech on receiving the Karlspreis, Aachen, 2 June.