LISBON COUNCIL 2011 EURO SUMMIT

Panel on "Europe Beyond the Crisis"

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It is refreshing to intervene at a conference which, even as market turbulence persists, spends some time away from immediate crisis management issues to engage in a more substantive discourse about what is needed to strengthen European productivity and competitiveness and to restore growth. This is very much the inspiration of the 2011 Euro Plus Monitor that Holger Schmieding has just presented, and these themes are of course at the center of the policy portfolio of the EU Council President, and our esteemed keynote speaker here today, President Herman Van Rompuy. It is indeed a tribute to him that he has managed to keep his eye on this ball as well, in addition to the many others that events have thrown at him.

Indeed, in the midst of it all, progress on strengthening EU economic governance has proceeded. As the Euro Plus Monitor's title puts it, there has been "Progress Amid the Turmoil," albeit at times painfully so and with frustrating delays. Yet, to use Galileo's phrase, it moves: just recently in fact, the Ecofin Council adopted the legislative proposals known as the "six pack," and agreed on the design of the so-called scoreboard of economic indicators, which is to be used under the new procedures to detect macroeconomic imbalances.

In this setting, the most instructive developments are those concerning Italy, because of what they tell us about the workings of an important element of the new governance mechanism – the European semester of policy coordination – and because of the unprecedented focus on structural policies (rather than on fiscal issues) offered by Italian case.

The main issue on Italy's policy agenda is indeed the realization of a comprehensive strategy to boost the country's anemic growth rate. This fits in well with the reform of EU economic governance, which is directed at placing greater emphasis on growth-enhancing structural reforms. Such reforms are now assigned at least equal standing to fiscal issues in the policy coordination embodied in the European semester process. As this audience no doubt knows (but sadly very few people outside the Charlemagne-Berlaymont-Léopold triangle that surrounds us), the European semester is a procedure aimed at ensuring ex ante coordination of national economic policies, and culminating, at the end of each semester, in specific recommendations for each of the 27 member states.

What happened in practice in 2011, in the first application of the European semester procedure? For its part, at the beginning of June 2011, the Commission duly issued its first set of specific recommendations for the 27 member countries. It was a good start: even jaundiced EU observers were generally struck by the specificity and candor of these recommendations. Importantly also, despite some initial concerns, the recommendations were approved without dilution by the European Council of late June 2011, which invited "all Member States to reflect them in their national decisions… and to address the shortcomings revealed by this exercise."

What happened then in Italy, the main Member State now in the cross-hairs of the crisis? At the European Council of late June 2011, Italy – as all the other member countries – fully subscribed to the recommendations it received, pledging to work toward their rapid implementation. In addition, as a participant in the new Euro Plus Pact, Italy also undertook to ensure "a broader scope [of the] commitments ... in order to foster competitiveness, for instance in network industries and the service sector." There was also the promise of "a more concrete approach… to make future commitments as specific and measurable as possible, giving details on how and when the commitments will be met."

How did Italy follow up on the recommendations it received, and live up to the commitments it undertook? Very simply, it did not. Or, more precisely, while action was taken on the fiscal side in the summer of 2011, nothing was done on growth-enhancing structural reforms.

Let us focus – by way of example – on a key recommendation, regarding greater competition – this is central to Italy's problems and undoubtedly a concern of the new Prime Minister, Mario Monti. In this regard, Italy was inter alia to "open up the services sector to further competition, including in the field of professional services" and to "adopt in 2011 the Annual Law on Competition, taking into account the recommendations presented by the Antitrust Authority." On the first count, nothing was done, so that ECB President Trichet and Bank of Italy Governor Draghi were forced to return to the subject in their letter of early August 2011, calling for "the full liberalization of local public services and of professional services." However, no specific legislation was submitted, so that Prime Minister Berlusconi's letter to the Presidents of the European Council and of the European Commission of October 26, 2011 could not go beyond mere declarations of intent in this regard. To the point that Commissioner Rehn, in his questionnaire of November 4 to Minister Tremonti, was induced to ask for “more details about the content of these measures.” As to the Competition Law, intended to be annual, it has never been enacted since its conception in 2009.

A similar picture prevails in other areas, with unfulfilled pledges on the labor market, pensions, and privatization. Thus, despite initial hopes, the European Semester process has clearly showed itself to lack teeth.

The reasons lie in three main shortcomings of the process.

A first shortcoming is that both the National Reform Plans and the Commission’s own recommendations are far too broad, trying to cover too many areas. This is partly a result of the fact that the framework document itself (the new Annual Growth Survey – AGS), published in January and intended to chart the direction for Europe over the coming year, is very broad. This is understandable, as it needs to cover the needs of a variety of countries, all exhibiting different roadblocks to growth. But ten priority actions in one year, as identified by the AGS, are too many for any single country.

What is the remedy? It should be to consider the AGS priorities as a broad menu, from which each EU country should pick and commit to 3-4 actionable reforms a year, chosen à-la-carte from this menu, according to their importance in unblocking domestic growth and to their national feasibility. This is a scope that would be both realistic and easily checked.

A second shortcoming is that the 27 leaders’ joint and blanket endorsement of the Commission’s recommendations, buried in the text of European Council Conclusions, are too vague and general to have any impact domestically. The Conclusions of the June 2011 Council simply read “The European Council endorses the country-specific recommendations approved by the Council…”. Which sounds pretty circular but, in euro-speak, means that – if one wants to know what the actual recommendations say – one needs to go back and find the Conclusions of the previous Ecofin Council.

This is no way to communicate, and it is a far cry from the transparent and inclusive communication strategy advocated by the Europe 2020 Integrated Guidelines, and aimed at enhancing the impact on national policy-making. To this end, the EU Council Conclusions should be clear and self-contained, specifying, for each country, the 3-4 actionable reforms that are identified for the coming year, listing them in individual country paragraphs, and with the individual Heads of state and government subscribing to them in a much more specific (and accountable) manner.

The third and final governance shortcoming is directly evidenced by the experience with Italy. Too much time was allowed to elapse without action by the EU institutions, even after the deadline specified in the Trichet-Draghi letter was disregarded.[1] Only at end-October was recourse made to quarterly EU Commission monitoring. Learning from this, quarterly EU updates of each countries' observance of the European Semester commitments should be the norm, rather than the exception.

Going forward, it is clear that Italy is going to be *the* test case for the exercise of EU surveillance. It is thus vital that it be as rigorous and candid as possible, fully "speaking truth to power."

The new PM Mario Monti is fortunately well-inclined to listen to such truth. Still, political parties will not make his life easy. This is where the international community, in the form of the IMF, could play a more incisive role. Some advise that this take the form of a traditional stand-by. In our view, however, unless market conditions precipitate, the need for financial support as such is arguable at this stage. But what *is* needed is the strengthening of confidence that can come from action that receives the Fund's seal of approval, via well-known and tested procedures that play a signaling role for the markets.

There is one such mechanism, instituted in the 1980s and known as the IMF's enhanced surveillance procedures, which aims precisely at maintaining market confidence and access. It was used most famously in the case of Colombia in 1984-85. At the time, Colombia asked the Fund to (1) certify that its adjustment program was strong enough to qualify for Fund financial support if requested; (2) monitor and evaluate progress exactly *as if* a stand-by arrangement were in place; and (3) release both the staff report and the Board's evaluation to its creditors. In other words, the authorities sought to have the Fund's "seal of approval" without the stigma that was seen to be associated with a formal Fund loan. Thanks to such "enhanced surveillance," Colombia was able to continue to receive bank credits and avoid a debt rescheduling, all the while not borrowing from the Fund, thus setting itself apart from its neighbors.

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[1] The letter set out a firm timeline for action, stating that, "in view of the severity of the current financial market situation, we regard as crucial that all actions listed [in section 1 and 2] above be taken as soon as possible with decree-laws, followed by Parliamentary ratification by end September 2011."

A similar arrangement may well suit Italy today. The current, somewhat unspecified monitoring agreed at the Cannes G-20 summit of November 2011 – without real agreement on what it should cover – could be transformed into a more formal enhanced surveillance procedure. This could provide a framework to confer credibility and reassure markets. It could also give the ECB (and in due course the EFSF) the grounds, via positive IMF signals, for continued bond purchases as needed. This approach is preferable to the anomaly of the ECB letter of August 2011. If matters were nonetheless to deteriorate, the framework could rapidly evolve into a regular program with access to Fund (and other) resources.

In sum, the recent political events and the advent of a Monti government provide Italy with the best opportunity in years for a comprehensive and credible reform strategy. But, given the fragmented nature of the Italian political system, and the make-up of its current Parliament, it is vital that the EU and the IMF keep the politicians' feet very close to the fire, and thus assist the reformists in the government. As The Economist recently put it: "For the euro to survive, Italy must succeed" and it is a collective responsibility to help it do so.