theLisboncouncil

e-brief

Issue 08/2010

Good Governance for the Euro Area: Proposals for Economic Stability

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'Who will guard the guards themselves?'
Juvenal

A single issue is dominating European-level deliberations, and deservedly so.[1] The issue is European Union economic governance – that is, how to equip Europe with rules, procedures, and institutions capable of ensuring the sustainable functioning of economic and monetary union for the indefinite future. The related stakes are high – indeed, no less than the future of the euro itself hangs in the balance.

Momentous Decisions – but Controlled, In-House Preparation

Have the preparations for these potentially momentous decisions, due to come to fruition in the coming months, been commensurate to their importance? On the one hand, recognition is due to the European Commission for thoughtful and wide-ranging proposals in May and June (with final proposals due by the end of September), albeit constrained by the limits of legal feasibility under the Treaty.[2] More boldly, the European Central Bank (ECB) abandoned this constraint, contemplating a "quantum leap" in EU governance in a paper presented in June.[3] Contributions have also been put forward by EU member states, though – with the exception of a joint Franco-German paper – these are not in the public domain.[4]

But the process whereby these various proposals will be sifted through and finalised for consideration by the EU heads of State and Government is unpromising. The work has been entrusted to a "Task Force on Economic Governance" headed by the first permanent president of the European Council, Herman Van Rompuy. Despite its resounding title, the "Task Force," set up in March 2010, is little more than a re-edition of the Economic and Financial Council (Ecofin), presided over by President Van Rompuy – composed, as it is, of the 27 EU finance ministers, plus Commissioner Olli Rehn, ECB President

1. The author would like to thank Paul Hofheinz and Ann Mettler for their encouragement and assistance in the preparation of this e-brief, and Anna Fosca for her constant and loving support. Also thanks to Stéphanie Lepczynski and Sylwia Stepien for their research assistance. As always, any errors of fact or judgment are the author's sole responsibility.

2. See European Commission, "Reinforcing Economic Policy Coordination," *Communication from the Commission* (Brussels, 12/05/2010, COM(2010) 250 final) and Ibid., "Enhancing Economic Policy Coordination for Stability, Growth and Jobs: Tools for Stronger EU Economic Governance," *Communication from the Commission* (Brussels, 30/06/2010, COM(2010) 367 final).

3. European Central Bank, *Reinforcing Economic Governance in the Euro Area* (Frankfurt: ECB, 10 June 2010).

4. Government of France and Government of Germany, *European Economic Governance: A Franco-German Paper* (Paris and Berlin, 21 July 2010).

‘No less than the future of the euro itself hangs in the balance.’

5. A laudable exception is in financial sector reform, where public consultation is quite regularly sought. See the European Commission’s special Markt Consultation Page on the web.

6. Alessandro Leipold, *Preventing Greek Tragedy from Becoming a Eurozone Disaster* (Brussels: Lisbon Council e-brief 06/2010).

Jean-Claude Trichet and Eurogroup President Jean-Claude Juncker – essentially the Ecofin formation. To the point that the Task Force’s meetings take place, as reported in the Ecofin’s own press releases, in “the margins of the Council.” This is not a Task Force in the customary acceptance of the term, i.e., an ad hoc group of experts charged with specific terms of reference to provide original and independent input to the decision-making process. It is, rather, a self-referential group of individuals who first deliberate in one format and then change hats to give those same deliberations a political *imprimatur*.

While the final decisions are per force political in nature, they – and the public debate – could only have benefited from a process that relied on unconstrained expert advice by the multitude of academics, observers, and think-tanks that have been studying and writing about the requirements of economic and monetary union for decades. Instead, the inbred procedures followed mean that input into the European Council’s decisions – in the form of the Van Rompuy Task Force’s final report – will, by the nature of its conception, be restricted to the minimum political common denominator. Not a promising approach a priori, and an unfortunate reflection of EU economic policy-making’s scant tradition of relying on public consultation and independent input.[5]

A Broad Range of Proposals, but Gaps Remain

The crisis – and notably the EU’s difficulties in dealing with the Greek situation[6] – has undeniably focused minds, leading to a comprehensive definition of the objectives, procedures, and instruments required for the EU’s effective economic governance. The ensuing proposals – politically unthinkable prior to the crisis – are largely apposite and would, if firmly implemented, represent appreciable steps forward. They would, in particular, fill one important gap: that of surveillance over macroeconomic imbalances and competitiveness developments.

But there remain critical gaps in the proposals that need to be addressed before decisions are finalised in the remainder of the year. In a nutshell, these are:

- The absence of mechanisms to secure and ensure financial stability as a vital short-, medium- and long-term objective of European economic governance
- An over-reliance on sanctions and scant attention to real incentives and genuine programme ownership
- Delayed work on a permanent crisis management and resolution mechanism

This e-brief will focus on the gaps in what has so far been proposed, looking to make recommendations for better, stronger economic governance in the euro area. For a summary of these recommendations, see the box on “Getting EU Economic Governance Right: A Nine-Step Programme” on page 3.

> 'There remain critical gaps in the proposals that need to be addressed before decisions are finalised in the remainder of the year.'

Getting EU Economic Governance Right
A Nine-Step Programme

1) Implement European Commission and European Central Bank proposals resolutely, avoiding political weakening in the Task Force's final report and the Council's decisions. The proposals so far are largely apposite and would mark noteworthy progress, but they need to survive the remaining negotiating process.
2) Enshrine financial stability as an explicit objective of economic governance. Adopt procedures to ensure close macro-financial integration and an operational role for the European Systemic Risk Board.
3) Provide incentives to countries to comply with common rules; redirect cohesion funds to address underlying causes of intra-EU imbalances.
4) Promote enhanced national ownership of reform and EU-agreed programmes, overcoming the "Brussels-talking-to-Brussels" syndrome.
5) Strengthen national fiscal frameworks, anchoring domestic rules firmly in EU requirements, monitored by independent national fiscal councils.
6) Establish an independent EU fiscal agency to monitor fiscal developments and raise the reputational costs of reneging on common commitments.
7) Promptly start work on creating a permanent EU crisis management and resolution mechanism that goes beyond the European Financial Stability Facility, while avoiding that moral hazard concerns impair its efficacy.
8) Establish and publish agreed principles and procedures for EU-IMF cooperation, with joint assistance being the accepted norm.
9) Recognise the ultimate need to go beyond the current Treaty for a full-fledged economic governance framework, and begin building the required consensus.

Ensuring Financial Stability: A Critical, but Missing Objective

The ultimate objective of EU economic governance is to ensure the sustainable functioning of EMU (Art. 121 of the Treaty) and, more broadly, economic stability and strong cohesion within the Union. To this end, official EU communications have consistently put forward three main pillars:

- Strengthening budgetary discipline
- Addressing macroeconomic imbalances and divergences in competitiveness
- Ensuring an effective framework for crisis management

These are indisputable objectives for effective economic governance, and the inclusion of the second and third points in recent reform proposals

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is an important (and overdue) recognition of glaring gaps in the current framework. But surely the crisis has revealed the importance of a fourth key objective, that of financial stability. It would be erroneous to subsume this under the heading of "macroeconomic imbalances," since – behind the appearance of relative macroeconomic stability – there can lurk serious financial fragilities and contagion risks. These will continue to go undetected without a full integration of macroeconomic and financial perspectives that draws attention to risks that originate in, or could propagate through, the financial sector. The need for such integration has been recognised at the G-20 level, with the creation and enlargement of the Financial Stability Board (FSB) and, in particular, the mandate given it and the IMF to collaborate in conducting Early Warning Exercises. It is also reflected in the experimentation in various countries with Financial Stability Reports, and the recent initiatives creating "Systemic Risk Boards" or analogous bodies in major countries.[7]

In contrast, official deliberations on strengthening EU governance to date largely overlook financial stability as an objective. Connected to this omission, there is hardly any mention of macro-prudential policy and also no concrete proposals to integrate the work of the new European Systemic Risk Board (ESRB), due to start in 2011, into the reformed governance framework (with only a passing reference in the Commission's Communication of June 2010). An exception is to be found, as could be expected, in the ECB's submission, but even in that iteration, the mechanism whereby the ESRB's analysis would find its way into official deliberations appears rather tenuous. As ECB Vice-President Vítor Constâncio explained in a recent speech: "Although limited to issuing warnings and recommendations, the participation in the [ESRB] of one representative of the Commission and the three chairs of the future European supervisory authorities ensures that proper action will follow the decisions of the ESRB."[8] But one can nourish legitimate doubts as to whether this will be the case in practice. Though admittedly far from easy, more specific and explicit means to ensure a full integration of macroeconomic and financial perspectives in assessing country-specific and systemic risks, with a clear role for the ESRB, should be an integral part of the EU's new economic governance structure.

Lots of Sticks, but Few Carrots

The dominant emphasis in the current reform proposals is on strengthening penalties and sanctions for miscreants, to "force" them to behave. This approach reflects a prevailing view that the EU's problems have stemmed essentially from weak implementation of good rules, and that better enforcement is thus key. A new sanctions toolbox is consequently proposed, with a wider range of penalties, a more rules-based or semi-automatic application, and an earlier recourse (i.e., with sanctions kicking in preventively, notably in the form of an interest-bearing deposit temporarily imposed on countries making insufficient progress

7. In the United States, the creation of a Financial Stability Oversight Council in the recent overhaul of financial regulation and, at EU level, the European Systemic Risk Board. In a parallel vein, at the IMF, the *Global Financial Stability Report* has acquired increasing prominence alongside the traditional *World Economic Outlook*.

8. Vítor Constâncio, *The Future of Euro Governance: How to Contain Imbalances and Preserve Financial Stability*, Speech to "The ECB and Its Watchers" conference (Frankfurt: ECB, 09 July 2010).

'Official deliberations on strengthening EU governance largely overlook financial stability as an objective.'

in budgetary consolidation). It is also envisaged to use the EU budget as leverage, with the *suspension of certain budget commitments* (e.g., transfers from regional, as well as agricultural or fisheries, funds) in case of excessive deficit (this would not immediately affect payments and would allow time for correction), and a *cancellation of these commitments and the definite loss of the related payments* in case of a country's non-compliance with the corrective recommendations. End-beneficiaries of EU funds (e.g., farmers and fishermen) would not be affected, with Member States having to continue to pay the farm subsidies, without being reimbursed by the EU budget. Unsurprisingly, these provisions do not figure in the joint Franco-German paper with France and Germany being large beneficiaries of the Common Agricultural Policy (CAP).[9]

At the same time, little attention is being paid to the possible role of "positive incentives" for good behaviour, such as "naming and faming" success stories. In a somewhat Orwellian twist, the punitive sanctions themselves are often referred to as playing the role of "incentives" (e.g., in the Commission's June Communication: "The deterrent effect of financial sanctions should constitute a real incentive for compliance with the rules"). Accordingly, the Communication makes only a passing reference to positive incentives, noting the possibility of "modulating co-financing rates or introducing a performance Union reserve to reward sound fiscal policies." Without any excessive illusion as to their efficacy, a role for positive incentives could be given greater attention in expanding the EU's compliance arsenal.

A common feature of the proposed sanctions – with the exception of the ECB's suggested but unlikely to be approved suspension of voting rights – is their financial or pecuniary nature. Such sanctions would thus tend to exacerbate the fiscal difficulties of a country already facing a severe imbalance – a feature which is likely to discourage their imposition when the time comes, as has been the case under the current Stability and Growth Pact (SGP). Despite repeated breaches, there has been no recourse to the SGP's available sanctions regime, with the November 2003 suspension of procedures against Germany and France being the most egregious manifestation of political discretion.[10] It is with this in mind that proposals have been put forth in favour of a rules-based approach in the application of sanctions, with forms of "semi-automaticity." In addition to procedural changes that would strengthen the role of the Commission (e.g., by requiring an explicit Council vote to reverse its otherwise automatic recommendation), the thought is to base sanctions on some progressive "traffic light" signals, with recommendations or penalties being triggered on the basis of "flashing" lights. Such a "colour-coded scheme of surveillance," designed to limit the degree of discretion, features prominently in the ECB's proposal, with countries being categorized as "green" (unproblematic), "yellow"

9. With regard to regional and cohesion funds more generally, it would be useful (as proposed in the latest IMF report on euro area policies) to work on redirecting their subsidies to remedy member states' major structural weaknesses, with cohesion policy thereby playing a larger role in providing incentives for the correction of the underlying causes of intra-EU imbalances. See also Philippe Legrain, *Beyond CAP: Why the EU Budget Needs Reform* (Brussels: Lisbon Council e-brief 09/2010).

10. As the ECB itself puts it in the 10 June 2010 paper cited above: "Insufficient peer pressure and peer support translated in a relative reluctance to give early warnings or candid and precise opinions and recommendations, excessive deficit procedures that extended over many months, and no recourse to the available sanctions regime."

'The dominant emphasis in the current reform proposals is on strengthening penalties and sanctions for miscreants. Little attention is being paid to the possible role of positive incentives.'

(problematic and potentially risky), and "red" (posing a very significant risk for the functioning of the euro area), with a related graduated increase in the intrusiveness of surveillance and the severity of penalties.

Some greater automaticity and reliance on rules over discretion would ideally be most desirable.[11] But one should be mindful of the approach's limits: the overwhelming evidence of international policy coordination and surveillance, embodied in the IMF and in EU experience itself, is that on-off triggers such as those under discussion do not work in practice, with peer pressure generally giving way to peer accommodation, amidst an overall reluctance to pull triggers. This is especially true where judgment has to be exercised in placing "labels" on countries, which is inevitably the case in assessing imbalances. There is thus little likelihood that any country would ever be tagged as being in an "excessive imbalances" position (as proposed under the EU's new competitiveness surveillance). The experience of the IMF since the changes to its exchange rate surveillance in 2007, and its failure to brand any currency as "fundamentally misaligned" (not very different conceptually from the proposed "excessive imbalances" position under EU surveillance) is instructive in this regard. After two years of frustrated attempts to apply the revised exchange rate decision and its "labelling" requirements, the Fund recognised that "the attempt to apply exchange rate-related 'labels' – for instance, the use of specific terminology such as 'fundamental misalignment' … – has proved an impediment to effective implementation of the Decision," with the result of "undermin[ing] Fund surveillance, running counter to the objectives of the 2007 Decision and damaging the Fund's credibility."[12]

There is of course a further difficulty: that of securing concrete policy action while "good times" still prevail but imbalances are nonetheless accumulating – which is the very spirit of preventive action. This resides essentially in the nature of crises, which typically stem from the confluence of two factors – an underlying vulnerability and a specific trigger.[13] Two conclusions follow. First, while the underlying vulnerability can and should be detected, the specific event that triggers the crisis is per se unpredictable, and so therefore are crises themselves – at least in their timing. Second, this unpredictability makes it difficult to persuade policymakers to take preventive measures, especially because the measures themselves are likely to be economically or politically costly. The fact that economists are unable to say exactly when a crisis will occur takes the bite out of their policy message. While any honest policymaker will acknowledge the risks, he will also cling to the hope – indeed often the belief – that the imbalances will unwind gradually and smoothly, in the sort of "soft landing" that invariably tends to be the official central scenario – inevitably so, for example, in Stability Programmes.

11. As Commissioner Rehn aptly commented: "It's a bit like a football game. It won't work if the players start to discuss and argue the rules of the game with the referee every time they commit a foul." Quoted in Marcin Grajewski and Paul Carrel, "EU Finmins Want Budget Rule Offenders Rapped Swiftly," *Reuters*, 06 September 2010.

12. See IMF, *The 2007 Surveillance Decision: Revised Operational Guidance* (Washington DC: IMF, 22 June 2009). In a similar vein, the EU has encountered continued resistance to "naming and shaming" attempts, most notably in benchmarking progress in structural reforms.

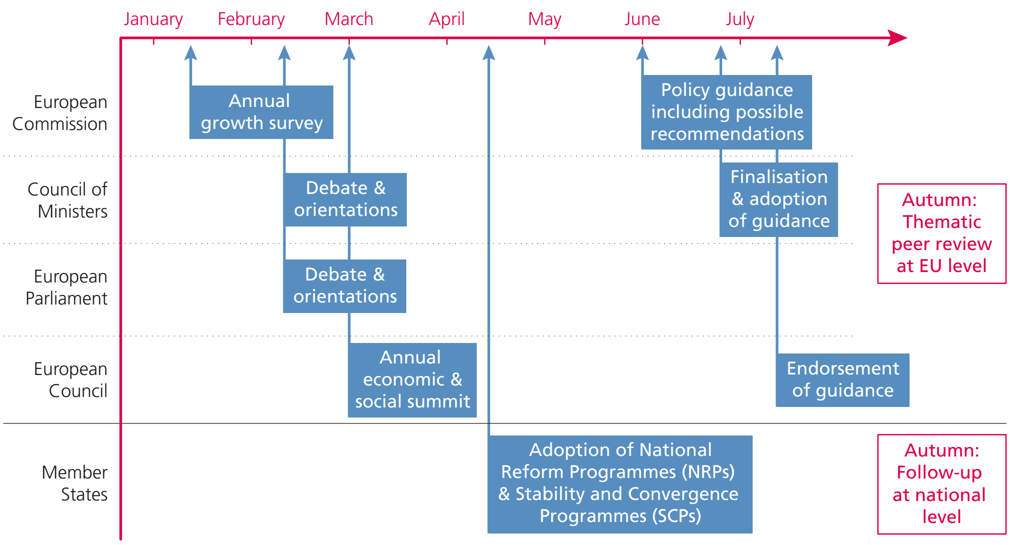
13. See Atish R. Ghosh, Jonathan D. Ostry and Natalia Tamirisa, "Anticipating the Next Crisis: What Can Early Warning Systems be Expected to Deliver?," *Finance and Development* (Washington DC: IMF, September 2009).

'There is little reason to expect that the European Semester will be any more effective or heeded at the national level than has been the case with existing processes.'

The European Semester of Policy Coordination – More 'Brussels-Talking-to-Brussels?'

Precisely because of such shortcomings of peer pressure and/or early warnings, the faith being currently placed on the so-called "European Semester of Policy Coordination" as a key tool appears overly sanguine. The process – which is to apply as of January 2011 – essentially envisages an earlier (spring) submission of member countries' Stability (or Convergence) Programmes and National Reform Programmes (NRPs), in order to synchronize assessments and ensure ex ante coordination, allowing more time for Commission and peer review, eventual recommendations, and modifications of national plans as needed (see Table 1 below for a description). Prior to the system's formal endorsement at the 07 September 2010 Ecofin, the Franco-German note to the Van Rompuy Task Force set clear markers limiting the reach of the exercise, saying it would have to avoid "encroaching on the budgetary prerogatives of national parliaments" and under a "timetable… flexible enough to take account of national budgetary procedures" – a potentially smothering condition.[14]

Table 1: European Semester of Policy Coordination



Source: European Commission

Beyond these (important) practicalities, a substantive unresolved issue is the very objective of ex ante coordination itself, and thus the criteria by which national fiscal plans will be assessed – i.e., whether the aim will be to achieve a given aggregate fiscal stance (which would indeed represent major progress toward developing a Community-wide fiscal policy) or, more modestly and likely, to assess the appropriateness of national fiscal plans from the perspective of individual countries' situation.[15]

14. For its part, the United Kingdom – where a budget is traditionally presented to Parliament in the spring – has obtained agreement to submit information for EU oversight only after it has been provided to the House of Commons. See Leigh Phillips, "Finance Ministers Give Green Light to EU Oversight of National Budgets," *EU Observer*, 07 September 2010.

15. Despite lip service to the role of coordination, the prevailing view among European policymakers continues to be that put forward by Alberto Alesina et al., *Defining a Macroeconomic Framework for the Euro Area – Monitoring the European Central Bank No. 3* (London: CEPR, 2001): "If the monetary and fiscal authorities 'keep their houses in order' acting on their own, there is no need for explicit coordination."

'The pursuit of binding fiscal rules by EU member states – if sufficiently widespread – would leave laggards with little choice but to follow suit, or markets would question their commitment to fiscal rectitude.'

But even abstracting from this, more deep-seated issue of the exercise's objective, there is little reason to expect that the European Semester will be any more effective or heeded at the national level than has been the case with existing processes – the SGP in the fiscal area and the Broad Economic Policy Guidelines (BEPGs) for structural reforms – with the BEPGs in particular being universally recognised as a failure. The European Semester thus risks being much as its predecessors, "a 'Brussels-talking-to-Brussels' exercise which remains unnoticed outside the triangle formed by the buildings of the Commission, the Council and the European Parliament," in the cutting words of economist Jean Pisani-Ferry.[16]

Enhanced Ownership, Stronger National Rules and Independent Fiscal Councils

So, if a sanctions-based system has its limits, if automaticity is politically unworkable (and also often analytically questionable), if early warnings in good times tend to go unheeded, if endless internal deliberations in Brussels remain domestically irrelevant, and if peer pressure often cedes to peer accommodation, what could still be done to reinforce EU governance? First, it is important to recognise that – despite all the noted limits – the main proposals on the table would still mark worthwhile progress with respect to the status quo. As such, they deserve support and follow-up, and will hopefully not be watered down in the remaining political decisions – having already been constrained by the process adopted and the limits defined by the Treaty.

The "Brussels-talking-to-Brussels" syndrome is in good part due to the fact that the documents being discussed – specifically Stability/Convergence Programmes and the National Reform Programmes – are virtually unknown within member states, are not part of the national public debate, and are ultimately removed from day-to-day policy-making (especially so for NRPs).[17] As such, there is little or no national ownership. A greater role of national parliaments in the approval of these documents could help enhance domestic awareness, debate, and ownership. Even so, the documents would likely tend to remain material prepared for Brussels, in response to a centrally-mandated requirement.

More promising, and definitely worth pursuing, are the Commission's and ECB's recommendations for stronger national frameworks and budget rules, with Belgium, Netherlands and Germany (with its new "debt brake" constitutional law) being possible examples. Indeed, the pursuit of binding fiscal rules by EU member states – if sufficiently widespread – would leave laggards with little choice but to follow suit, or markets would question their commitment to fiscal rectitude and exact onerous risk premia. The Commission is thus undoubtedly correct in noting (in its 30 June Communication) that "EU fiscal surveillance would improve if fiscal rules and a credible enforcement mechanism are already well-embedded into national rules and institutions." Similarly, the ECB notes the importance

16. Jean Pisani-Ferry, "Only One Bed for Two Dreams: A Critical Retrospective of the Debate over the Economic Governance of the Euro Area," *Journal of Common Market Studies* Vol. 44, No. 4, pp. 823-44. As noted in the same piece, in only one case was a recommendation for violating the BEPG issued by the Council (Ireland in 2001), and it was ignored by the recipient government.

17. Lamentably, this is true also for Europe's new blueprint, Europe 2020. Ann Mettler, *If Not Now, Then When?* (Lisbon Council e-brief 07/2010): The fact that the new permanent Council President, Herman Van Rompuy, has been entrusted with the work on economic governance has likely also distracted from the Europe 2020 Strategy, originally his main remit.

> 'The leisurely pace being adopted underestimates the likely obstacles to the creation of a permanent crisis management and resolution mechanism. The sooner work starts in earnest, the better.'

of "enhancing national fiscal frameworks, by promoting a strengthening in national legislation of national fiscal rules and institutions consistent with the provisions of the EU fiscal framework, approved by national parliaments and monitored by independent national budget offices or fiscal institutions." The Commission has undertaken to make formal proposals specifying the minimum requirements for the design of domestic fiscal frameworks, even suggesting that infringement proceedings could be instigated in the case of failure to comply. These steps are likely to be resisted, but should be pursued resolutely. In doing so, the Task Force (and Council) would do well to heed the ECB's recommendation in favour of "independent national budget offices or fiscal institutions."

The ECB's proposals go one important step further in this respect, advocating the creation of "an independent EU fiscal agency." Though the rationale of placing this agency "preferably within the Commission" (in the ECB's formulation) is unclear, its creation would act to enhance pressure for fiscal rectitude and application of the rules in individual member states and at Community level. Independent monitoring and public assessments of commitments under the SGP could serve to raise the political or reputational costs of reneging on such commitments.[18] Interestingly, the joint Franco-German paper also mentions drawing on "a specially appointed group of independent experts" – this cryptic reference will hopefully be fleshed out in the Task Force's final recommendations. The recommendations could also usefully seek means to reward countries with best-practice institutions of fiscal governance.

Urgent: Work on a Permanent Crisis Management and Resolution Mechanism

The creation, under duress from the Greek crisis, of a European Financial Stability Facility (EFSF) "to provide a funding backstop should a euro area Member State find itself in financial difficulties" seems to have removed any sense of urgency from working toward a permanent crisis management and resolution mechanism. The EFSF, which only became fully operational in August 2010, is a temporary mechanism, due to expire in June 2013.[19] Official thinking seems to be that work on a permanent solution can be postponed until this deadline or thereabouts. The prevailing approach is to wait for experience with the EFSF, conduct a subsequent "impact assessment," and formulate proposals for a permanent mechanism only in the medium- to long-term.[20] There is a connected subtext that – should the EFSF remain unused in its three years of existence – a permanent mechanism would likely come to be seen as dispensable. This would be a gross error – all the more inexcusable now that experience has exposed the deceptive nature of the sense of security that lulled policy makers during the prolonged period of stability, dubbed the "great moderation," that preceded the latest crisis.

18. Xavier Debrun, "Gaps in the Euro Area Fiscal Framework: Options for a New Fiscal Contract," *IMF Country Report No. 10/222, July 2010.*

19. For details, see EFSF's Framework Agreement.

20. Consistent with this approach, the Franco-German paper refers to "building on our experience" and foresees the establishment of a crisis resolution framework "in the medium term."

‘While first principles would ideally demand re-opening the Treaty, much can be done even within its confines.’

The leisurely pace being adopted underestimates the likely obstacles to the creation of a permanent mechanism and institution. One need only recall the last attempt in this direction when, at the Bremen European Council of July 1978, the heads of state and government declared that they “remain firmly resolved” to create a European Monetary Fund (EMF) “no later than two years” after the creation of the European Monetary System, i.e. by 1981. As noted in Lisbon Council e-brief 06/2010: “The plan foundered on a host of legal, political and economic obstacles – none of which have diminished in the intervening 30 years – on the contrary.” In light of this experience, the sooner work starts in earnest, the better.

Once it does, some current misapprehensions should be set aside. While concern about the moral hazard inherent in “bailing out” wayward countries is understandable, the safeguards being sought are ill-conceived. These safeguards (as listed in the ECB’s submission) focus on making the instrument “very unattractive,” to be used only “as a last resort,” provided “at penalty rates,” and under pledge of collateral. These punitive notions all run counter to the needs of a country facing a crisis: i.e., in essence, an instrument that is accessible early and pre-emptively (hence, for example, the precautionary nature of IMF Stand-By Arrangements), with financial conditions that, while remaining market-related, are not penalising. While stringent policy conditionality is of the essence, it should in itself suffice to allay moral hazard risks. The intent surely cannot be that of adding further financial strain on a country in already dire straits. Such an approach would exacerbate already existing obstacles to a timely recourse to financing and adjustment, heighten the mechanism’s stigma, increase the political reluctance and delays in requesting it, and feed the deterioration of the situation – ultimately requiring both more financing and sharper adjustment. It is instructive that the IMF, with a long-standing experience in crisis lending, has been moving in precisely the opposite direction, with increasing recourse to its Emergency Financing Mechanism in order to respond rapidly, and an expansion of its crisis-prevention toolkit to include early intervention mechanisms (with an enhancement of its Flexible Credit Line and a new Precautionary Credit Line).[21] Though some of these instruments are not readily applicable to the reality of advanced euro area economies, the difference in philosophy and approach is noteworthy.

In addition, any future EU crisis management and resolution mechanism should include principles and procedures for cooperation with the IMF. A framework for joint EU-IMF assistance should be established, in the form of a public document – a sort of Memorandum of Understanding – outlining principles and procedures for cooperation. This would help frame and stabilise market expectations. After the mixed signals and harmful procrastination on Greece, joint EU-IMF assistance should become the norm, with sole intervention of either institution being the unlikely, and generally undesirable, exception.

21. IMF Enhances Crisis Prevention Toolkit, Press Release No. 10/321, 30 August 2010.

‘Let us hope that Jean Monnet was right: “Europe will be built in crises, and will be the sum of the solutions brought to these crises.”’

Several observers have noted that a full EU crisis resolution regime should also include some form of Debt Resolution Mechanism. There is no doubt value in this proposal, but its dimension needs to be that of an international – rather than solely European – workout mechanism. Despite the difficulties encountered by the proposal for a Sovereign Debt Resolution Mechanism (SDRM) made by Anne Krueger in 2001, the time and the forum (the G-20) may have come for a renewed international effort on this front. Countries with unsustainable debts need to be able to resolve them promptly and in an orderly way. At present, the only available mechanism – the international community bailing out private creditors – is clearly unsatisfactory.

Ultimately, Europe Needs to Go Beyond the Current Treaty

As noted, current discussions on EU economic governance have been deferential to the limits posed by the existing Treaty. This is a *realpolitik* recognition that there is no will to re-open the Treaty, and that indeed Europe’s citizens themselves remain resistant to advanced forms of centralisation and to the cession of powers that would be implied, for example, by fiscal federalism. While the long-running debate on whether a common currency *per force* requires a common polity (political union) remains unsettled, I am of the view that ultimately a shift in policy authority to the centre would be highly beneficial, if not essential, for the smooth workings of the euro area. This will obviously take time, but it would be useful to begin preparing the ground, building consensus via an ongoing process of economic pedagogy by the Commission and enlightened policy makers in this direction.

In sum, while first principles would ideally demand re-opening the Treaty, much can be done even within its confines, if these are fully exploited. This e-brief tries to identify some of the gaps in the present proposals and discussions, in the intent of ensuring – as decisions are taken between now and the end of the year – that Europe will not let “a good crisis go to waste.” Let us hope – for the future of the euro itself – that Jean Monnet was indeed right when he proclaimed that “Europe will be built in crises, and will be the sum of the solutions brought to these crises.”[22]

22. “L’Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises.” Jean Monnet, *Mémoires* (Paris: LGF, 2007).

The e-brief series is published on the editorial responsibility of the Lisbon Council asbl.
The responsible editor is Paul Hofheinz, president, the Lisbon Council asbl.

ISSN: 2031-0935

Design by www.karakas.be