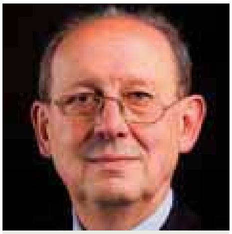
How the eurozone's political elite should recover its leadership

The euro system is looking like a challenge to economic common sense, says Carlo Secchi. He sets out the steps that Europe's political class must summon up the courage to take

The debate on improving economic governance in the eurozone is shedding new light on the euro system's weaknesses, although they were already quite evident when the Maastricht treaty was signed in 1992, and just happened to have been forgotten during the common currency's first decade.

It has long been clear that a monetary union with a common monetary policy would be unsustainable in the long run, without something of a similar nature in the fiscal domain. This became true in light of the growing heterogeneity in public accounts and in the economic performances of the countries concerned. The well-known conditions of the theory of "optimal currency areas" were far from being met.

Now the euro system looks more like a challenge to economic common sense, consisting as it does of a centralised monetary policy run by the European Central Bank (ECB) but decentralised fiscal and budget policies. The Growth and Stability Pact (GSP) that was meant to guarantee fiscal discipline and co-ordination hasn't been taken seriously by important states like France and Germany since the first half of the last decade.



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Nevertheless, the euro undoubtedly produced such significant benefits as a boost to intra-European trade, unprecedented stability and lower inflation in many member states. It quickly became the world's second most important currency and proved itself to be a shield against outside financial turbulence. This caused over-optimism, with acceleration in many fields where more prudence would have been advisable, witness the admission to the euro club of countries like Greece that should have waited longer and the rather quick "widening" of the EU to eastern Europe even though little "deepening" was taking place.

In other words, Europe's decision-makers came to overlook the basic requirements of a monetary union in a heterogeneous economic area. It needs:

- a sizeable common budget for the provision of public goods;
- fiscal transfers from more prosperous areas to those in economic difficulties;
- some form of communitarisation of public debt (i.e. eurobonds), carried out under stringent rules;
- and, above all, a central bank with all the necessary prerogatives and instruments, including the "parachute" to the whole system deriving from being a "lender of last resort".

These conditions would, of course, lead to fully-fledged political union, but the process can yet be developed in a gradual way, either with a form of banking union, or a fiscal union, or a central bank acting as lender of last resort. This would be in line with the functionalist approach and might be more acceptable in practice. Some say, though, that this would imply solidarity to a degree difficult to accept, although forgetting the "social market economy" model so clearly stated in the Lisbon treaty and disregarding the fact that solidarity is the other side of the coin of enhanced interdependence that a monetary union brings about.

The final outcome of a monetary union must be a positive sum game for all participants, otherwise it won't survive for long. After the eurozone's sovereign debt crisis broke, measures were taken to avoid defaults, included the European Financial Stabilisation Mechanism (EFSM), later substituted by the European Stability Mechanism (ESM), together with a more pragmatic and reinforced role for the ECB, acting with the International Monetary Fund (IMF). In March of this year the Fiscal Compact foresees a commitment to budget balance guaranteed by a constitutional law in each state, together with an obligation to reduce public debt to within 60% of GDP in 20 years.

Any assessment of moves toward better economic governance has to acknowledge the contradictory and slow decision-making process at intergovernmental level, where in many instances a misperceived sense of national interest together with upsurges in anti-European public opinion and electoral tactics have led to a stop-and-go process, with the financial markets aggravating instead of improving the situation. The European political class has demonstrated a clear lack of leadership.

Citizens see brighter future with EU economic government

Leaders struggling to agree on plans to improve economic governance for the euro area can take some comfort from the support, at least in principle, from their citizens.

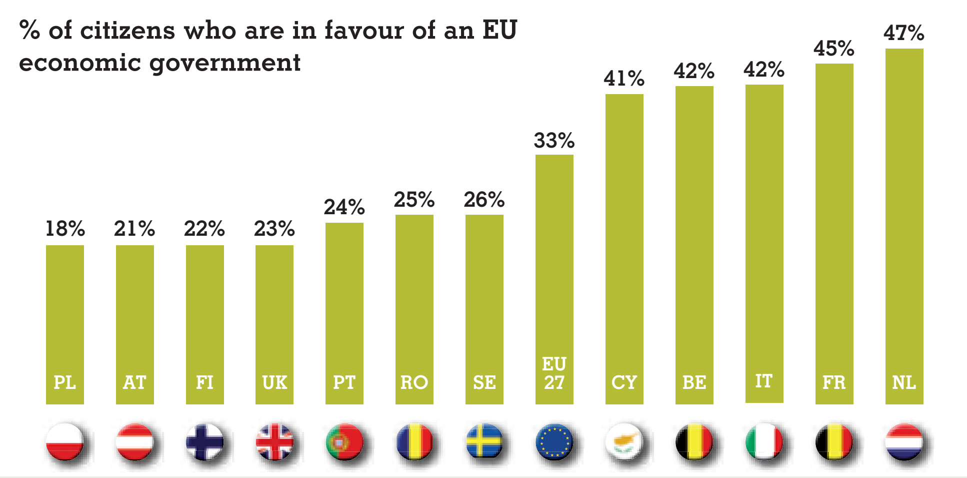
Asked to pick two measures most likely to give Europe a brighter future, 38% of eurozone citizens selected "an economic government for the EU," according to a Eurobarometer poll published in April. Only the creation of comparable living standards scored better.

Support was highest in two countries on opposite sides of the "triple A" divide with citizens in the Netherlands and Italy making it their top priority.

Forty-seven percent of Dutch and 42% of Italians selected economic government ahead of such options as comparable economic standards, well-defined external borders or a common EU army.

Over 40% in Belgium, France, Cyprus and Slovakia also went for economic governance, along with 35% of Germans. Support was lowest in Estonia, Austria and Finland, at less than 25%.

Outside the eurozone backing for an EU economic government was weaker. The lowest rating – just 18% – came from Poland, the only member state to have avoided recession since the crisis erupted in 2007.



Source : Special Eurobarometer 379

The challenge now is twofold: how to cope with the financial crisis and how to create a safer situation in the future through better governance.

Measures to resolve the financial crisis have so far been slow and insufficient, so the problem in many countries has been aggravated. Excessive emphasis on fiscal rigour accompanied by measures to stimulate growth has reinforced recessionary trends placing additional strain on public budgets. The uncertainty created can be seen in the spread on some countries' government bonds contributing further to the vicious circle.

Any lasting solution to all these problems involves acknowledging at a political level that we Europeans now face a common problem that can only be resolved by greater cohesion and financial solidarity. At a technical and operational level, the ECB must move away from its present ambiguous status to really become Europe's central bank, with all the necessary power and instruments that include being a lender of last resort. The European banking system must be turned into a banking union with prudential supervision under the ECB's responsibility. The Fiscal Compact must be quickly implemented, and progress should continue to gradually harmonise fiscal policies.

But fiscal discipline must be accompanied by growth policies as these are of vital importance if we are to turn the vicious circle of fiscal deficits, austerity and rigour, then recession and increased deficits into a virtuous one. Without growth, budget balance and debt reduction will quickly become unsustainable. The "Europe 2020" strategy approved two years ago (including its improvements in economic governance) is a good starting point, offering the basis of the "Growth Compact" that has been asked for by some EU governments.

All this requires two fundamental conditions. First, economic governance must be improved at a political level, with "more Europe" involving the further strengthening of the roles of the European Parliament and the Commission, and the complete abolish of veto powers in the Council. "More Europe" obviously implies a strengthening of our common institutions, but the argument that this would cause reductions in national sovereignty appears very weak, since sovereignty in today's globalised economy is in any case more apparent than real.

In parallel to these changes, there must be a clear acknowledgment by European leaders that if the euro falls not only will the eurozone fall apart but the same will happen to the EU. European public opinion has to be made aware that with our increasing interdependence, the gradual completion of the single market and the stability of exchange rates provided by the euro offer benefits for us all.

But if the euro falls, we will quickly go back to competitive devaluations, intra-EU protection and "beggar-thy-neighbour" policies, the situation that was still evident in the 1970s and 1980s. Europe's political class needs to find the courage to take the next steps towards a closer union, and understand that the small price nation states will have to pay is negligible compared to the likely consequences of not taking action.

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Commentary

No, 'more Europe' simply isn't the best way forward. People don't want it

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Carlo Secchi's article is a succinct summary of the europhile consensus on key elements of the eurozone crisis, yet many of the points he makes are questionable even for those like myself who support the single currency.

First, his diagnosis of the crisis is supposed to remind us that the eurozone doesn't meet the criteria for an optimal currency area. Indeed it does not, but then again which large country in the world does? It's true that the United States has a federal budget that does more to compensate region-specific shocks than labour market flexibility. But since the onset of the present crisis, the existence of this federal budget has meant that some states were free-riding on Washington's stabilisation efforts and in some cases actually undid some federal stimulus effects through their own pro-cyclical austerity measures. This may sound extreme, but it is exactly what the constitutional debt brake of the fiscal compact is now trying to achieve: balanced budgets in the member states.

The theory of optimal currency areas only takes into consideration temporary transfers in the case of exogenous shocks that hit one region harder than others. Greece, the one country whose sovereign debt was clearly the cause of the national crisis, has no case to make for such transfers. Very low real interest rates in fast-growing regions that have led to private over-indebtedness are not a good reason for proponents of the theory to advise against a common currency. In other words, the theory is quite simply useless for understanding this crisis, and is merely a convenient pretext for asking for more structural reform. This may be necessary, but it won't make the European Monetary Union (EMU) more resistant to crisis. If it did, Ireland wouldn't be in such hot water.

Second, I have difficulties with Secchi's critique of crisis management. As a member himself of the European political class, Secchi tells us that it "has demonstrated a clear lack of leadership". That is to say that they have not convinced voters that "more Europe" is the solution to every crisis. But you cannot label it voter ignorance when electorates apparently think that it is instead a formula for ever-more intrusive oversight of national budgetary policies. Nor is it sheer stubbornness when voters in creditor countries reckon that "more Europe" sounds like paying for debt incurred in the past over which they had no control and from which they have received little in the way of obvious benefits.

There is a new divide within the European Union. Until now, the EU contained openly redistributive programmes for a few designated funds and for agricultural and regional policies from which poor regions even in wealthier member states could benefit. We now face a situation resembling the rift between southern and northern Italy, where the poorer regions have access to an overdraft facility in the shape of a federal budget. The inevitable result is a strengthening of separatist movements, although in contrast to national democracies the EU doesn't have the political means to bind these forces into a single coalition and government system.

Carlo Secchi has a solution to all this, of course, which is "more Europe". The European Parliament and the Commission should be strengthened and all the veto powers of the Council should be abolished. This would be the best recipe for destroying the EU and uniting voters in a backlash against European integration. Even the Commission has shown better political instincts than that, and has invented the new co-ordination mechanism of the European Semester. It could give national parliaments a say in the fiscal surveillance process, although it is so far a top-down process with an overloaded agenda. But making national parliaments more vocal, and consulted on a regular basis rather than in emergencies, would in principle be the best way forward for Europe's political integration. ■

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