Economic governance in the euro area: lessons from the Greek crisis

Panel remarks by Athanasios Orphanides, Governor of the Central Bank of Cyprus, on the "Greek Financial Crisis" at the Center for Financial Studies Research Conference

Athens, 24 September 2010

I would like to thank the organisers, especially Michalis Haliassos, for inviting me to this conference to participate in this panel on “The Greek financial crisis”. As Greece is rebuilding its economy, undergoing, step by step, long overdue structural improvements, the prospects of the brighter future these changes will bring offer a reminder that crises are also opportunities for progress. Crises bring to the surface neglected policy priorities, forcing us to reflect on why the system failed and inviting us to seek needed improvements.

The sovereign crisis we have been experiencing in Europe over the past many months has exposed fault lines in the economic governance of the euro area. The ensuing debate presents an opportunity to strengthen the existing framework—reinforcing economic governance. With this in mind, in my brief intervention, and following a few words on the Greek situation at present, I will focus on the lessons that can be drawn regarding the improvements we should seek in the economic governance of the euro area.(1) Before proceeding, I would like to note that the views I express are my own and do not necessarily reflect the views of my colleagues on the Governing Council of the European Central Bank.

***

Looking first at the Greek situation at present, we can see the political dilemma faced so often by policymakers who must explain the trade-offs involved in incurring short-term pain to secure much greater long-term benefits. These trade-offs often lead to inaction in tackling structural problems, with disastrous costs at a later date. For many years in Greece, we observed procrastination in dealing with structural difficulties in the economy, resulting in the loss of economic competitiveness. Furthermore, we now know that public finances were unsound, building a large fiscal imbalance whose magnitude was only recently revealed to all. The country was not fulfilling its potential. But this is now changing. The Greek government should be commended for taking the long view and implementing the courageous programme of economic reforms. I have confidence that successful implementation of the reforms that are under way will revitalise the Greek economy, boosting the economy's potential and raising the welfare of the Greek people. At the same time, we cannot overlook the justified bitterness over a turn of events that unavoidably entails short-term sacrifices which the general public was not prepared to encounter following the merry years before the storm. But such is the disappointment that always follows overindulgence based on unrealistic expectations. The short-term pain experienced during the adjustment is unfortunate but, at this very late stage, it is unavoidable in order to ensure a restoration of the country's solid development prospects. The more the adjustment is delayed, the greater the accumulated cost to the Greek economy and its citizens. Together with a stronger economy, I am also hopeful that the reforms will elevate the level of democratic discourse and debate, as the public becomes more aware of the harm caused by short-sighted populism and learns to better evaluate the long-term damage it imposes on society.

***

Let me now turn to what went wrong from a euro area governance perspective, and how to move ahead. In brief, one could simply point to insufficient government discipline: insufficient competitiveness discipline, that is, a failure to avert widening differences in competitiveness across the euro area; and, more importantly, insufficient budgetary discipline. As a group, the governments of euro area member states appeared not to have the proper incentives to gear domestic policies in a manner that would ensure compatibility with a common currency area. This is why the problem can be identified as one of economic governance in the euro area. To this effect, the Task Force to the European Council, chaired by President Van Rompuy, is presently preparing a report on improving economic governance in the Union, with particular emphasis in the euro area. The Commission and the ECB are also contributing their input to the Van Rompuy task force and some of the suggestions made are reflected in my discussion later on.(2)

The foundations of stable economic growth require an environment of price stability. The Treaty entrusts the conduct of monetary policy to an independent institution, the European Central Bank, with a clear mandate to deliver on this objective. Importantly, to ensure that the central bank will be able to deliver price stability, the Treaty prohibits monetary financing and effectively insulates it from the fiscal authorities of member states. One benefit of this framework is that not only can the ECB deliver price stability but it can be trusted to do so consistently over time, thereby contributing to an overall environment of lower long-term interest rates and financing costs in the euro area as a whole than would have been possible without as high a degree of credibility. Thus, a member state joining the euro area, in addition to benefiting from a stable currency, can expect an associated benefit that over time should enhance growth prospects and welfare. But as a corollary, the credible prohibition of monetary financing also eliminates the possibility that a member state could ever attempt to rely on debt monetization as a tool for maintaining a fiscal imbalance. This, in turn, makes the pursuit of sound public finances all the more important for macroeconomic stability. The importance of sound fiscal policies for preserving the stability of the euro was recognised in the Stability and Growth Pact (SGP). The Pact was meant to provide a mechanism that would prevent excessive deficits from emerging and quickly correct them if they materialised so that debt levels would remain comfortably low. However, the Pact has, in the main, failed as member states have demonstrated little ownership of fiscal targets to which they were committed.

The failure has been multifaceted. One failure has been that at a broad macroeconomic policy level, in some member states, including Greece, insufficient attention was given to the opportunities and constraints of being part of the common currency area. The benefits arising from joining the euro area—a more stable currency, easier access to credit and lower financing costs—were not properly taken advantage of. The unique opportunity to promote greater productivity and higher sustainable growth was lost. Furthermore, during the calm before the storm, market forces did not exert sufficient discipline on budgetary excesses, thereby exacerbating imbalances and setting up a harsher fall once the party was over.

There has been a failure in budgetary reporting and surveillance. Arguably the most shocking development in this regard was the sudden revelation of the size of the fiscal imbalances in the Greek economy that were hidden until the situation became critical. The experience highlighted the need for improved reporting by member states as well as more effective surveillance. At the national level, setting up an independent budget evaluation agency could provide a cross-check to the budget authority of each member state and greatly improve the reporting of budgetary data and analysis to EU bodies and other euro area governments. Such an authority could report directly to the parliament of the member state so that its reports could be independently assessed and compared to the government's budget proposals during parliamentary hearings. Greater transparency and consistency can also be achieved by adopting a multi-year fiscal planning horizon in budget discussions and incorporating extra-budgetary items, including contingent liabilities, such as unfunded future pensions. Leaving such items out of budget discussions and debt and deficit analysis, inhibits dealing with them in a coherent manner. At a European level, surveillance could become more effective if the powers of Eurostat were enhanced so that it could check in greater detail the quality of reported data. In addition, an independent EU-wide fiscal agency could be mandated to scrutinise fiscal projections by member countries, with intrusive investigations in cases where there are debt or deficit concerns. Greater fiscal policy coordination could also be envisaged among euro area member states, such as the adoption of stronger fiscal rules setting limits on the growth of expenditures as a way to secure the necessary budget consolidation in case of excessive deficit or debt ratios.

There has also been a failure of enforcement of budgetary discipline and proper reporting. Without proper incentives to ensure that it is respected, no framework, however well designed, can be effective. The development of a credible enforcement mechanism is an indispensable element of improved governance. Proper incentives could come in the form of clear, quasi-automatic sanctions for misbehaviour by a member state. *Ex ante* agreement and quasi-automaticity are essential to eliminate the political impediment that would arise from an *ex post* application of the Council's discretion. In addition, to encourage continuous compliance, sanctions should be meaningful and should be applied relatively early. They could include financial sanctions, such as reduced access to EU funds, as well as non-financial sanctions, such as a limitation or suspension of voting rights.

Many of the improvements in the governance framework that are under discussion could be pursued without changing the Treaty. Indeed, the new Treaty provides a framework within which to improve the workings of the euro area. I note, in particular, the new wide-ranging provision in Article 136 of the new Treaty that is specific to the euro area. It states that: "In order to ensure the proper functioning of economic and monetary union … the Council shall … adopt measures specific to those Member States whose currency is the euro: (a) to strengthen the coordination and surveillance of their budgetary discipline; (b) to set out economic guidelines for them …" (European Commission, 2008, p. 106).

Let me now turn to an additional observation regarding the sovereign crisis that could also be characterised as a failure, but in a different, deeper sense than described so far. That is a failure in European solidarity. The European project is still very much under development, reflecting the gradual pooling of the economic and social fabric of our societies, in the interest of all citizens of Europe. We all recognise that as the social and economic ties of the member states get stronger, especially so in the euro area, our fates become increasingly interconnected, our interests largely common. This calls for greater cooperation and coordination by member states. The people of Europe seem to understand this. According to the latest Eurobarometer public opinion poll, 75% of Europeans agreed that stronger coordination of economic and financial policies among EU member states would be effective as a means of combating the crisis. But looking back at the last few months, the process of reaching agreements on the handling of the sovereign crisis in the euro area has raised questions regarding solidarity among member states. Some object to greater cohesion and indications of mutual support among euro area member states suggesting this would be paramount to transforming the EU or the euro area into a so-called transfer union, where resources are being transferred from one state to another. But this is not the issue. Neither the European Union nor the euro area needs to become a transfer union to allow for greater cohesion and solidarity. Mutual support during a crisis, on the basis of clear *ex ante* agreed rules, does not imply a transfer union. It does, however, imply the presence of a mechanism that can be seen as providing mutual macroeconomic stability insurance among the member states of the euro area. Such insurance should be welcome. If well designed, this would increase the level of confidence in the whole area.

Doubts regarding European solidarity have been harmful to the euro area, especially the weakest member states. I agree with those who suggest that to make progress in this direction, we should contemplate more and not less European integration, at least in the euro area. Reflecting on the recent challenges, ECB President Trichet succinctly put it as follows: "Working together to meet these challenges is not just an act of solidarity; it is very much in the best interests of all participating countries and their citizens. Monetary Union is not a matter of convenience; it offers us protection and improves resilience, provided that we embrace the underlying ideas and principles" (Trichet, 2010).

The creation of the the European Financial Stability Facility (EFSF) can be seen as a step in this direction. The EFSF was created in May 2010 to address tensions in the euro area sovereign debt markets and provide some direction as to how a member state could be offered assistance to overcome a crisis. However, as of yet there are no practical examples as to how it could be used to ease tensions. In the meantime, as developments in bond markets suggest, tensions remain in the sovereign markets. European Union and euro area economic governance are still works in progress.

* * *

As a closing thought, it could be considered that, ultimately, improving economic governance in the euro area to the greatest possible degree, may require that member states give up some powers, in the name of better cooperation and improved enforcement of the commonly agreed rules that enhance stability in the euro area. The ideal design would ask fiscal policymakers to give up part of the power that allows them to pursue unsound fiscal policies for a time. Ultimately, the ideal mechanism would help policymakers avoid temptations. Specifically, it would guard against the temptation to procrastinate on fiscal matters; and the temptation to pursue policies offering a small short-term gain for the electorate, at the cost of a large longer-term loss. In this corner of Europe, where the sirens lived and Ulysses sailed the Mediterranean Sea, it has long been understood that giving up some power can be beneficial. But it is also well remembered that the trip to Ithaca was long and arduous. With courage and determination, I am confident that we can reach the goal of a better Europe. This should be how the Greek crisis is remembered in years to come.

ENDNOTES:

(1) See Bini Smaghi (2010), Gaspar (2010), Pisani-Ferry (2010) and Strauss-Kahn (2010) for recent related expositions.

(2) See Council of the European Union (2010), European Commission (2010a, 2010b) and European Central Bank (2010).

REFERENCES:

Bini Smaghi, Lorenzo (2010) Intervention in ECON Committee Hearing on 'Improving the Economic Governance and Stability Framework of the Union, in Particular in the Euro Area', 15 September.

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

European Commission (2008) Treaty on the Functioning of the European Union, *Official Journal of the European Union,* C 115, 9 May.

European Commission (2010a) *Reinforcing Economic Policy Coordination*, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social

Committee and the Committee of the Regions, COM(2010) 250 final, Brussels, 12 May.

European Commission (2010b) *Enhancing Economic Policy Coordination for Stability, Growth and Jobs – Tools for Stronger EU Economic Governance*, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social Committee and the Committee of the Regions, COM(2010) 367/2, Brussels, 30 June.

Gaspar, Vitor (2010) "How to regain confidence in the euro area?", contribution to a panel discussion at the conference 'The Euro Area and the Financial Crisis, hosted by the National Bank of Slovakia, Bratislava, 6-8 September.

Pisani-Ferry, Jean (2010) "Euro-area governance: what went wrong? How to repair it?", *Bruegel Policy Contribution*, June.

Strauss-Kahn, Dominique (2010) "Towards a new fiscal framework for the euro area", address at the Bruegel – IMF Conference 'Sovereign Risk and Fiscal Policy in the Euro Area', Bruegel Institute, 14 September.

Trichet, Jean-Claude (2010) "European integration: the benefits of acting collectively", speech at the Ferl Foundation award ceremony, Kalsersaal, Frankfurt am Main, 9 June.