Lorenzo Bini Smaghi: European democracies and decision-making in times of crisis

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Hellenic Foundation for European and Foreign Policy, 8th European Seminar 2001, Adjusting to the Crisis Policy Choices and Politics in Europe, Poros, 8 July 2011.

* * *

Thank you very much for inviting me to address this conference in Poros.

I would like to speak about a very topical theme: the capacity of democracies to take difficult and pressing decisions in critical times. The sovereign debt crisis has brought this issue to the fore in both creditor and debtor countries in Europe. Recent experience has shown that tough decisions are often taken only on the brink of the abyss, when the fateful consequences of not taking such decisions become all too evident to governments and to those they govern. This creates at least five highly undesirable outcomes, in particular within the European context.

First, it increases uncertainty in financial markets about the course that will ultimately be followed. This explains why spreads have systematically increased when decisions were postponed, even when clear deadlines were set.

Second, the longer a decision is delayed, the more unpalatable it ultimately becomes, as the action required to calm the markets and to restore stability has to be even stronger. This applies not only to the measures which are needed to correct the budgetary imbalance but also to the size of the financial package required to support the country which no longer has market access. An example: if Greece, and the Eurogroup, had not waited until May 2010 to address the crisis but had done so several months earlier, the fiscal adjustment would probably have been milder, market access would not have been so impaired and the size of the financial support by the other countries would have been smaller.

Third, by putting off difficult decisions until the very last moment, interim or partial solutions tend to be adopted, instead of more lasting ones. Crises then drag out as one quick fix gives way to another without the underlying weakness being addressed. An example: last year's less-than-stringent stress tests in certain euro area countries failed to take account of concerns about the robustness of the financial sector, so the exercise is being repeated this year.

Fourth, as the sequence of quick fixes proves to be ineffective in getting to the root of the problem, reform fatigue starts to spread and people become less willing to accept increasingly unpalatable measures. The result is a blurring of the difference between the negative but short-term impact of the necessary adjustment on the one hand and the disaster which would result from inaction on the other. This in turn increases the risk of taking the wrong – irrational – decision. The narrow vote in favour of the adjustment programme in Greece at the end of June 2011, amid widespread protests and with strong opposition in parliament, illustrates this risk.

Fifth, if people do not realise how close they are to the abyss, and thus do not support the adoption of the unpalatable decisions, policy-makers have to make them aware of the risks by appealing directly to them, which may in turn frighten and unsettle the markets. For example, in May 2010 the claim that the euro was at risk, which was made in countries like Germany to justify the creation of the European Financial Stability Facility, added to market turbulence and may, over time, cause citizens to lose confidence in their currency.

These outcomes are mutually reinforcing and can lead to a perverse spiral. In the European context, this applies not only to the countries in distress, which have to implement tough adjustment programmes, but also to the countries which are expected to provide financial support conditional on the implementation of the programmes.

These collective action dilemmas in decision-making do not apply solely to European democracies. The current debate about the debt ceiling in the US, with some politicians openly speculating about a technical default, is a clear example of democratic decision-makers avoiding tough decisions until they are pressured to make them. Similarly, Lehman Brothers' failure in September 2008 showed that waiting for too long on the brink of the abyss does not necessarily lead to the right decision. It showed, too, that the costs of a disaster are much higher than those arising from unpalatable decisions taken at an early stage.

What makes the difference between the euro area and other cases is that failure to take prompt action in the latter is considered to be a policy mistake, even if it has dire consequences, but it does *not* call into question the whole institutional and political set-up. When Lehman Brothers collapsed and the US Congress initially voted down the TARP in September 2008, the dollar was not considered to be at risk. In Europe though, a crisis is sometimes considered by outside observers as putting the euro, and the Union itself, at risk of disintegration. Academics and other experts deliberate on whether the euro area is viable and how it can be rescued. Closet eurosceptics suddenly reappear, dusting off their I-told-you-so commentaries. And politicians feel compelled to restate their faith in and commitment to the euro and the Union.

The issue is all the more surprising given that, overall, the euro area is progressively recovering from the 2008–09 recession, with some countries performing strongly. The average budget and deficit in the euro area is substantially lower than in other parts of the world. Its labour market has proved more resilient and industry more competitive. The three countries in distress under the IMF/EU adjustment programmes account for about 6% of euro area GDP. Furthermore, we should not forget that we have experienced the biggest economic and financial crisis since the Second World War.

The euro is a construct without precedent and was hit by the crisis before reaching the age of ten. Had it been perfect from the start, from conception to launch, and capable of facing up to all possible challenges and crises, the single currency would have been a miracle. The crisis has shown that the euro is an incomplete construct and needs to be completed. This incompleteness has compounded the difficulties that our democracies face in taking unpalatable decisions in difficult times, and thus it increases the risk of postponing those decisions for too long.

For the euro to grow stronger as a result of this crisis, we need to understand its shortcomings and address them. More importantly, we should not delude ourselves that the euro can be strengthened just by copying other models. For instance, we often hear that unless the euro is backed by a fiscal union, as in the US, it cannot survive. Reasoning by analogy is not only wrong in this specific case, it is impractical and politically unrealistic. But this should not discourage us from looking at long-term solutions, even if they require Treaty changes.

While considering such solutions, let me raise a few issues which, in my view, have not been fully addressed in the recent debates and which should help us to better understand the challenges ahead. My main thesis is that monetary union entails in itself a much greater degree of political union than many commentators, politicians, academics and even the public ever thought. This is due to the fact that, in a monetary union, decisions taken in some parts affect other parts, in a very direct and sometimes dramatic way. Even more importantly, in a monetary union, some specific national problems can only be dealt with through decisions taken jointly, with a euro area perspective. In concrete terms, the problems currently affecting Greece, which accounts for 2% of euro area GDP, are influencing the whole of the area and need to be resolved through tough decisions, not only in Athens but also in Brussels.

The fact is, the people of the different Member States have not fully understood that we already have a political union. Furthermore, the institutional framework does not provide a decision-making process that is fully compatible with such a political union. Let me elaborate.

A starting point is the limited awareness of the euro's political dimension. That dimension results from the interconnectedness of the financial markets and the transmission of real, monetary and financial impulses within the area. As a result, governments and citizens throughout the monetary union should not only be concerned about what happens in their respective countries, but also in the other countries, because the latter can have a direct impact on their lives. In other words, it's not sufficient for each member of the union to keep its own house in order, so that its underlying economic, financial and budgetary conditions are consistent with a sustainable membership of the euro area. The others have to do the same. There must thus be a mechanism of mutual monitoring of economic development and policies which ensures that all members comply with the requirements. This demands active participation by the different governments in the supervision of each others' policies. This has however not been the case in practice.

Governments have a mandate from their respective national electorates mainly to take policy decisions for their own countries. There is limited awareness in the domestic political arena that governments are also responsible for monitoring the other members of the euro area, in particular in respect of the Stability and Growth Pact (SGP) and ensuring that they abide by it. In concrete terms, if a country records a budget deficit which is found to be excessive in the sense of the SGP, it is certainly that country's responsibility to correct it promptly. However, it is also the responsibility of the other countries, within the procedures established under the SGP (which also foresee an initiator role for the Commission) to ensure that the correction is fully and vigorously implemented. In other words, if a country does not comply, it should be pressured by the others. And if the others do not do this, they also become responsible for such non-compliance. This was the political motivation for establishing the SGP.

EU Member States, their governments and citizens, do not seem to be fully aware of such a sharing of responsibility. As Mario Monti recently put it, governments are too polite to each other, maybe in the expectation that if they find themselves being accused of the same transgressions one day, they would then benefit from the forgiveness of the others. Such a "non-aggression pact" between potential offenders tends to lift the burden of responsibility from countries and creates a form of moral hazard, which encourages indiscipline.

The decision taken by the ECOFIN Council in November 2003 not to act on the Commission's recommendations regarding excessive deficit procedures against France and Germany may have sown the seeds for such non-aggression pact between countries in the budgetary surveillance procedure. It may also have weakened the surveillance mission of the Commission, thus undermining the political basis of the monetary union.

To sum up, in such a union, governments should be accountable not only for their own policies, but also for checking the policies of the other members. Voters should hold their representatives accountable for their domestic policies and for how they act under the SGP in constraining the policies of the others, because these policies, especially if they are out of line, will affect them in turn.

No such system of accountability has existed so far. This does not mean that it's too late to start it. People in Europe now want to know why surveillance was not sufficiently robust before the crisis and why certain countries were admitted without having a sufficiently strong institutional framework that could prevent a build-up of excessive debt, public or private. These questions need to be answered if the mistakes of the past are not to be repeated. The attempt by certain politicians to shift the responsibility for monitoring and disciplining other countries' policies to the financial markets betrays the spirit of the union, which is based on strong budgetary rules to be implemented and monitored by the member states. As we know, markets often react late, tend to over-react and to be pro-cyclical, behave as a herd and follow acritically rating agencies. Policy makers cannot complain about this behaviour – occasionally even threaten market participants with coercive actions – and at the same time delegate to these same markets the fate of their economies.

Another problem which arises from the still essentially domestic nature of political life in Europe is the lack of understanding of the global dimension of the euro. Discussions on economic and financial policies are conducted in each country largely on the basis of national information and national considerations. There are very few places where a euro-area-wide view is held, the ECB being one of them. This may in part be due to the fact that the euro area has no true financial centre that all Europeans can look at to understand how markets affect their everyday lives. Financial integration has moved forward, but not yet to the point of transforming national savers into European ones.

As a result, policy-makers tend to take decisions related to the euro area mainly from a domestic perspective, taking into account the national electorate, national parliament and national economic conditions. Let me give a couple of examples of this, relating in particular to the sovereign debt crisis in Greece.

It has proved difficult in many countries outside Greece, especially in those where the economy has been recovering well and unemployment falling, to fully grasp the global ramifications of the crisis, the potential for contagion and thus the ultimate risks to taxpayers even in the creditor countries. The German parliament in May 2010 called on Jean-Claude Trichet and Dominique Strauss-Kahn to explain the risks associated with the Greek crisis, because Berlin's outlook was different: the German economy was recovering well and no dangers were evident.

Another example is the attempt to involve private creditors in the financing of the Greek adjustment programme. While this objective is generally welcomed by some countries' taxpayers – who certainly are attracted to the idea that their money should not be used to bail out banks – it can under certain circumstances – in particular in the midst of a financial crisis – lead to outcomes which are even more costly for them. Policy makers should explain under which circumstances forced involvement by the bondholders would entail higher costs for taxpayers. This is not an easy task because it requires putting rational arguments before emotional feelings. The main objective of some elected politicians seems instead to accommodate the instinctive reaction of their national electorate, even bashing the central bank when it tries to bring some rationality in the discussion. As a result, sub-optimal decisions are taken, as the experience since mid-October 2010 has shown.

Adding to this complexity is the general tendency of the national media to reflect mainly national views, and to overlook giving the diversity of perspectives and the broader European view. When difficult decisions have to be taken which involve potentially conflicting interests between countries, particularly between debtors and creditors, the national media tend to adopt extreme positions and to resort to stereotypical descriptions of the others. We have seen examples of such behaviour in some Greek and German newspapers. A more moderate "European" view, which tries to explain the common interest, has great difficulty in finding an audience in the various countries. This makes it even more difficult for national politicians to search for compromise in the broader European, and ultimately national, interest.

National governments have to take their parliaments' views into account, which is perfectly understandable. However, this may paralyse European decision-making, especially if it is based on inter-governmental agreements and requires unanimity. This is not the case for most decisions foreseen in the Treaty, such as those underlying the functioning of the SGP. However, unanimity was required for several decisions which were taken in the crisis, in particular with respect to financial assistance.

The sovereign debt crisis has shown the need for a safety net for those governments which lose access to financial markets while undertaking an adjustment programme. Such a net had to be rapidly put in place in the form of the European Financial Stability Facility, with the long-term solution being a modification of the Treaty and the creation of the European Stability Mechanism. In all these cases, unanimity is required for all decisions, not only in the set-up of the scheme, but also in its modification and activation. This is a clear shortcoming. It would be as if the IMF had to gain the unanimous support of its Executive Board to decide on each and every country programme. No doubt it would severely impede and delay decision-making at the IMF. It is surprising that European countries have accepted a majority, or a qualified majority system, at the IMF – in which paradoxically the US has enough votes to block some decisions – but require unanimity to decide among themselves, within the European mechanism, thus making it very difficult to decide, especially at times of crises.

When taking critical decisions that affect the stability of the euro area, the European Council risks becoming like the Polish-Lithuanian Commonwealth of several centuries ago, in which any member of the legislature could block *any* decision. We know how it ended.

Such a system is certainly not the best way to manage a major currency area. The ECB has expressed its views on this in the past and hopefully some changes will be made in the light of experience.

So how can we improve the institutional framework in Europe?

In my view, we should strengthen the capacity of EU institutions to take collective decisions. This would require three components: first, reducing the degree of inter-governmentalism in decision-making and thus diluting the unanimity principle; second, strengthening the rules that constrain national decision-making; and third, establishing a more effective enforcer of those rules.

I have already mentioned the weaknesses of the decision-making process when addressing crises. There are counter-arguments to my view, which have been put forward by distinguished commentators and policy-makers. However, experience – the exchange rate mechanism and the debt crisis are two examples – has shown that under such a mechanism decisions are systematically taken too late and that the burden on taxpayers ultimately increases. All those who attach importance to the interests of taxpayers should reflect on this. Let me be clear. I am not calling for a fiscal union or fiscal transfers to be decided through a majority system. I am just warning that unless decisions concerning the implementation of a financial safety net are taken more efficiently, i.e. through a communitarian approach based on majority decisions, as is the case at global (IMF) level, the risk of implicit transfers will actually increase, which may not be in the interest of most taxpayers. Experience of over 50 years has shown that IMF shareholders, i.e. taxpayers, have never lost money under such a system. Why innovate? There are many other areas where European creativity can be better put at work!

The second component – strengthening the rules – is already under way at EU level via the economic governance reform package. While we still have some misgivings about the current proposals – which in our view do not go far enough – progress is being made. In particular, the SGP should have been further streamlined to avoid drawn-out procedures and reducing the margins for discretion through the greater use of reverse majority voting. The European Parliament has in any event pushed hard in this area, but at the current juncture it remains to be seen how successful its efforts will eventually be.

Much can be done also at national level, without having to change the Treaty or EU secondary law. For instance, the introduction of debt ceilings into national legislation that are consistent with stability programmes approved by the Council would arrest excessive debt growth even before EU procedures were initiated. Rather like “neighbourhood watch” programmes in local communities, this would also spread policing responsibilities and involve national parliaments and fiscal institutions in enforcing the rules.

Debt ceilings, however, contain an inherent “good times” bias – there is nothing to prevent national governments infringing them when difficult decisions about adjustment and consolidation have to be taken. One way to prevent this – and to ensure that decisions are in the collective interest – would be to make public debt issuance a union competence for euro area countries. Member States could transfer to a supra-national agency the right to issue their debt, up to levels agreed by the Council in the context of the yearly approval of the stability programmes. It would no longer be possible to issue debt to cover expenditure over the debt limit set every year.

Had such a system been in place, Greece would neither have been able to hide nor incur the higher deficits and debts in 2009 or in the preceding years. It would have been forced to adopt corrective measures at a much earlier stage. The same would have applied to other countries.

This strong constraint – a genuine "debt brake" – would force a country to make an early decision when its public debt gets too close to the agreed limit. Either it would come up with immediate additional consolidation, or it would have to request the support of the European Stability Mechanism to finance its residual deficit. In this latter case consolidation would happen via an adjustment programme and strong conditionality. In both scenarios, the damaging effects that deferred decisions have on the rest of the euro area – as we have witnessed with every financial assistance package over the last year – would be mitigated.

This is not a proposal for so-called Eurobonds. National treasuries would still be responsible for their own debt, and there would be different debt instruments from one country to another, but the total amount for each country would have to be approved by the Eurogroup, as is currently done for the yearly stability programmes, and it would be binding. There would be no need for explicit or implicit transfers, or tax sharing – ideas often included in Eurobond proposals – as the costs of an excessive fiscal policy would remain with the country concerned.

The third component in strengthening euro area decision-making is to establish a strong enforcer of the rules. In this regard, the euro area faces its own "impossible trinity": countries do not want to exert peer pressure; the Commission prefers to mediate than to police; and the IMF is only an occasional player in EU affairs. As the euro area has to have a way of both monitoring policies and ensuring their compatibility with monetary union, one of these has to give.

This applies not only to fiscal policies but also to other policies which can cause imbalances within the area.

In my view, the change has to come via the Commission, in particular by clarifying its institutional function and improving its independence. The former could be achieved by enhancing the role of the Economic and Monetary Affairs Commissioner in the correction or, ideally, the prevention of improper budgetary policies, and by giving him or her a strong mandate to rigorously enforce the rules and sanctions.

These proposals for stronger rules and tougher enforcement naturally raise questions of accountability. Democracies take their time because a wrong decision, or even a prudent decision that the public does not fully understand, will incur voter displeasure on election day. But if the recommendations of a stronger enforcer of the rules do not produce good outcomes, who is to hold him or her accountable? This is a very complex question which I cannot fully address here. One solution might be to have the European Parliament more involved.

But ultimately an enforcer of rules cannot be held accountable for outcomes. The responsibility falls on democratically elected governments to agree the right rules *ex ante* and give the enforcer an appropriate mandate. If outcomes are unsatisfactory, governments must change the rules and mandates, and explain why to the public.

Let me conclude. Winston Churchill said: *"You can always count on Americans to do the right thing – after they've tried everything else"*. The last 18 months suggest that Europeans, too, may do the right thing, after trying everything else. However, in today's world, with sophisticated financial markets, deferring decisions creates uncertainty, entails substantial costs and may undermine the political cohesion of the Union. This is particularly the case when, as J.K. Galbraith observed: *"Politics consists in choosing between the disastrous and the unpalatable"*. To see disaster looming before choosing the unpalatable is a dangerous strategy.

European history before the creation of the EU is full of examples of irrational, emotional – and sometimes dramatic – decisions which have actually aggravated a crisis instead of resolving it. The European Union has helped to avoid any repetition of such tragic mistakes over the last 60 years, thanks to some visionary leaders and strong institutions.

A further strengthening of the institutional framework is now required to help our European democracies take timely decisions in a global world. This in turn means that the euro area's institutional model has to be adapted to the fact that monetary union is a political union. Like all innovations, a process of steady adjustment and refinement is needed in order to create the finished product. The way ahead is not necessarily to imitate other forms of political union – such as the United States' fiscal federation. Europe's undertaking has no precedent. It demands original thinking, as much as, if not more than, that of America's founding fathers in their times. It certainly also demands their courage and leadership.

Thank you for your attention.