François Villeroy de Galhau: Europe at a crossroads – how to achieve efficient economic governance in the euro area?

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, recorded for the event at Bruegel, Brussels, 22 March 2016.

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Summary

There is a growing perception of the ***need to rethink the economic governance of the euro area***. Compelling ideas have been put forward to that effect; yet their implementation is tricky, especially in the present climate of Euroscepticism.

Shifting from ideas to action has become urgent if monetary policy is not to remain the only game in town. Clearly, the single monetary policy cannot be a substitute for the coordination of national economic policies or the lack of reforms. To be sure, the debate over EMU reform is politically loaded; but for euro area citizens the poor coordination of national policies involves ***a high cost in terms of growth***, of several points of GDP. The economic case therefore needs to be made: this discussion is not about "more Brussels", it is about more growth and jobs in Europe. In addition, it is not a choice between domestic reforms or European coordination; we need both.

Between complete integration – of the monetary-policy type – and monitored national policies, as currently conducted, the missing link is ***"full coordination" of fiscal and structural policies.*** This is clearly shown in a matrix crossing these three degrees of integration and the four policy dimensions (monetary, financial, fiscal and structural).

This full coordination of national fiscal and structural policies can only be achieved by setting up a legitimate decision-making institution, embodied by a ***euro area Finance Minister***, whose role is here concretely specified. This would make the euro area more than the sum of its parts.

Within a mandate to achieve the strongest, sustainable and balanced growth, this institution's role would be to prepare and propose the ***euro area collective strategy***, and to supervise its implementation by Member States. Furthermore, the Finance Minister would also be responsible for implementing efficient crisis management. While moving towards further integration, the Minister could be given the authority to manage a euro area Convergence Fund, ***evolving in three stages towards a euro area budget***.

In all events, the Minister will need to be backed by: a legitimacy-enhancing appointment process; a genuine Treasury administration; and a strong democratic control over euro area affairs.

To echo Robert Mundell, economic policy as a whole "isn't just the best game in town, it is the only game", not monetary policy alone. We cannot afford another missed opportunity: for EMU, for its citizens, 2016–2017 is the decisive time to act.

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All of us probably agree that there is one necessity: the euro area needs to rethink its economic governance, notwithstanding significant institutional changes implemented during the crisis. Progress is badly needed, although progress is very difficult to achieve, in a climate of growing Euroscepticism. I want to pay tribute to Helmut Schmidt, one of the greatest Europeans, who said clearly in Frankfurt in October 2011: "There was a failure to

set the economic rules of the game for the currency union. A powerful authority with responsibility for fiscal and economic policy was not set up."[1]

In that spirit, I speak today as a committed European and a contributor to EMU since its outset, as well as a Member of the ECB Governing Council. Some of the ideas I will elaborate upon were put forward in my February joint paper with Jens Weidmann, even though what I will say today does not necessarily represent his views or those of other colleagues of the ECB or, naturally, those of the French government.

While such ideas to enhance economic governance are not all new, their implementation is tricky: this will be the main thrust of my speech. Shifting from ideas to action is urgent if central banking is not to remain the only game in town. For this reason notably, central bankers can legitimately contribute to the debate. Yet, taking action will obviously be a decision for political leaders.

This issue has already generated many prominent contributions: for instance Jean-Claude Trichet[2] in 2011 advocated the need for a European finance minister; Mario Draghi[3] called, in early 2015, for a "quantum leap" in European integration and institutional convergence and Ignazio Visco[4], last November, wished parallel and decisive progress on political Union. Although I cannot quote all contributors, Bruegel has also promoted a European fiscal capacity and a stronger coordination of economic policies, along with Jean Pisany Ferry and many others.[5]

Last year, the Five Presidents Report, followed by the EMU pack of the European Commission reflected a more consensual view of how to deepen and strengthen EMU in four different areas: financial, fiscal, economic, and political – and with two different horizons, the short term and the long term, recognising that the latter may require a revision of the Treaty.

How to reform the Euro Area(EA)'s economic governance is the subject of a loaded but much-needed debate requiring some principled choices (I). Among the latter, I will elaborate on the priority towards a "full coordination" of national economic policies, and the subsequent need for a strong EA Finance Minister with very concrete tasks I will detail today (II).

I. The loaded debate we must have and some fundamental principled choices.

A. The debate is loaded because of at least three fault lines.

First, in the relationship ***between the EA and the rest of the EU***, deepening integration across both perimeters at the same time, let alone at the same pace, is not warranted. This raises the prospect of a multi-speed Europe, especially at a time when EU membership could become a reversible matter. We shouldn't fear different speeds. In clearer terms: whatever the limits of the February "Brussels agreement", I am strongly in favour of the UK remaining within the EU; yet, irrespective of the outcome of the British referendum, the EA can and should pursue further integration.

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1 Helmut Schmidt, Remarks at the Farewell event for European Central Bank President Jean-Claude Trichet, October 19, 2011.

2 *Building Europe, building institutions*, Speech by Jean-Claude Trichet on receiving the Karlspreis 2011 in Aachen, 2 June 2011.

3 Speech by Mario Draghi, President of the ECB, at SZ Finance Day 2015, Frankfurt am Main, 16 March 2015.

4 *European Union: progress or regress?,* Dinner speech by Ignazio Visco, Governor of the Bank of Italy, Istituto Affari Internazionali 50th Anniversary Conference, Rome, 13 November 2015.

5 Agnès Bénassy-Quéré and Xavier Ragot, Conseil d'Analyse Economique, *A Policy Mix for the Euro Area*, March 2015 , or Daniel Gros and Cinzia Alcidi, European Parliament In-Depth Analysis, *Economic policy coordination in the euro area under the European Semester*, November 2015.

Second, tensions and heterogeneity ***within the EA***, especially between the so-called core and periphery, have been exacerbated by the crisis so that the prospect of risk sharing may be perceived as involving permanent transfers across economies. Pooling risks would thus be seen as involving moral hazard, with permanent suspicion of "free rider" behaviour. Yet, we must realise that heterogeneity across countries calls for reinforced cooperation, based on risk reduction together with risk sharing. It is the only way forward to resolve the tension between solidarity and responsibility.

Last, on the crucial issue of economic governance for the EA, ***France and Germany*** have not always seen eye to eye. In Germany, "economic government" as advocated by Pierre Bérégovoy in the early '90s, was originally seen as a threat to ECB independence and is now viewed as a new trick to avoid implementing domestic reforms. To be fair, the French call for Germany to support coordination, and the German doubt about French reforms, have been and are still both well-founded. A weak outcome would be that nothing would happen before the French and German elections of 2017. But even in this case, 2016 can and must be a year of intense preparation.

B. Why this remains a necessary debate and why we must make the economic case

We know there is deep political resistance to sharing fiscal resources and sovereignty, as well as Euroscepticism and lack of a sense of national ownership of European matters. The sad example of the refugee crisis illustrates how European countries so far have displayed little solidarity to find a common solution. From a political economy perspective, this can be seen as tension between national preferences and common interest.

This is why we need to make the economic case. If we are to promote a stronger governance of the euro area, it cannot be a purely institutional case out of blind belief in ever closer integration. It is not a theological issue and not solely a political one either. It is a very concrete tool to achieve the full economic potential of the euro area. We must strive to reach such an agreement for the good of the citizens of Europe. It has to be grounded in candid economic analysis and empirical evidence. This discussion is not about "more Brussels", it is about more growth and jobs in Europe.

Clearly, ***monetary policy cannot be a substitute for economic policy coordination or the lack of reforms***. The ECB has worked extremely hard to fulfil its mandate. Yet, there are economic and even political risks to overburdening monetary policy: these are risks to financial stability, to the proper functioning of credit channels, and to central bank independence, as enshrined in the treaties. For that reason alone central bankers need to take part in this debate. The way we have handled the crisis has shown how unprepared and uncoordinated we were. Not only did this episode affect our credibility, it also revealed the economic costs of non-coordination in terms of prevention and management of crises, both at the national and collective level.

At the national level, Member States have been lacking the capacity to mitigate large shocks in the EMU context. The non-binding nature of economic policy coordination, as set out in the Lisbon Strategy or the Agenda 2020, is partly to blame. Some Member States also proved to be poorly committed to implementing domestic structural and fiscal reforms that would have created more policy space to address shocks. ***Collectively***, the expected dynamics between peer pressure and market discipline did not work, as markets did not believe in the no-bail-out principle, and as national authorities did not really accept peer pressure, nor the implementation of the rules.

The absence of coordination has a genuine economic cost. Several studies have estimated it for the EA. It includes a) the cost of crises and assistance programmes, as well as b) the impact on growth due to uneven compliance with budgetary rules before the crisis and rigidity of the rules during the crisis. Let me mention a few numbers. Banking and fiscal crises can be extremely costly: relative to the U.S. growth trajectory, the EA has fallen behind

by 5 percent of GDP per capita since 2011. Both the European Commission[6] and the NIESR[7] have shown the large impact of simultaneous fiscal consolidation in Europe, with around 2% larger GDP declines due to intra-EA spillovers. Optimal policy coordination in the EA would have required differentiated consolidation efforts in line with available fiscal space, leading to better growth outcomes.

A last illustration relates to asymmetric adjustment driven by current account imbalances at the country level at the beginning of the crisis and contributing to the large external surplus at the euro area level today. A surplus of more than 3 % of GDP, for an economic area which still has a negative output gap of more than 2%, is clearly suboptimal.

In sum, all these figures point to a significant cost of non-coordination, of at least 2% of the EA GDP at present.

C. To take the debate forward, three principled choices have to be made.

These principled choices are needed: (i) to resolve the debate between coordination and reforms; (ii) to simplify rules and embrace institution-based policymaking; in order (iii) to achieve full coordination.

First, ***we do not have to choose between coordinating economic policies and domestic reforms***. This is the cornerstone of any French-German agreement: breaking the political gridlock on coordination versus reforms, and making parallel progress on both domestic reforms and European coordination. This requires overcoming distrust and putting both aspects under the same umbrella, namely a common institution.

Second, ***institutions with a mandate are superior to rules without institutions***. To bolster policy consistency and coordination, we admittedly need simpler rules. For instance, the complexity of the reforms of the Stability and Growth Pact (SGP) and the so-called "Fiscal Compact" is such that Finance ministers privately admit they do not know whether their country is completely abiding by the rules. But we learnt in real life that we cannot rely simply on rules. They should be supported by strong institutions with discretionary powers. Mario Draghi pointed out the fundamental difference between a monetary policy institution and fiscal rules, which are exemplified by the track records of the ECB and SGP respectively.

Third, there is room for an intermediate level of integration, which I would call "***full coordination of national policies***", a presently missing link between integration, as we have for monetary policy decision-making, and rule-based surveillance such as is currently the case for national fiscal policies. To illustrate this, a matrix is obtained by comparing the 4 components of economic policy (monetary, financial, fiscal and structural) in columns with the 3 levels of integration in rows: namely the lowest level of "monitored national policies" (with recommendations), the intermediate level of "fully coordinated national policies" (with incentives) and the upper level of "integrated policy" (with common instruments). The four components of economic policy displayed here are quite distinct, but they all contribute to the same objective: to boost growth but also to smooth shocks. Their classification is organised more or less – from left to right – in terms of their effect on stabilisation vs. allocation, in other words of their cyclical vs. structural effects. I do not need to elaborate on monetary policy. As a complement to monetary union, economic union can be seen as the combination of three main policy instruments: (i) financial, (ii) fiscal and (iii) structural. All three policy dimensions indeed have a supply-side impact on resource allocation (to a growing extent going right).

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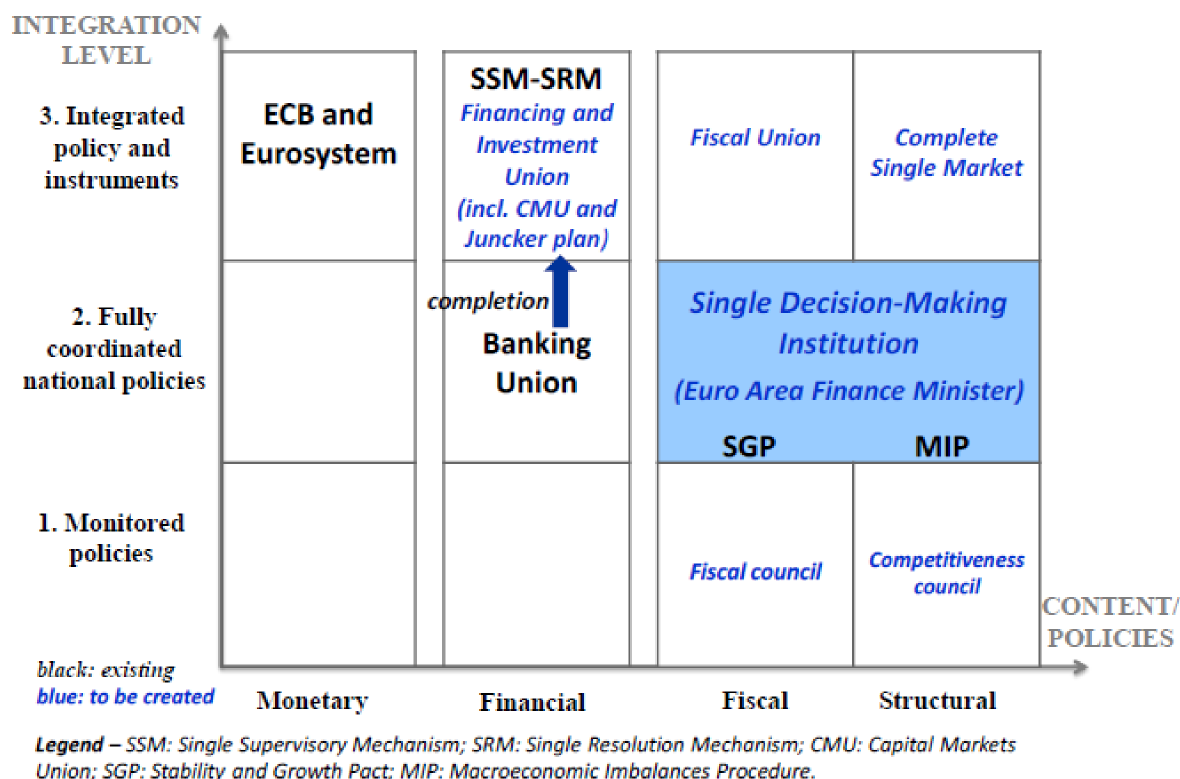
[6] Jan in't Veld, *Fiscal consolidations and spillovers in the Euro area periphery and core*, European Commission Economic Paper 506, October 2013.

[7] Dawn Holland and Jonathan Portes, *Self Defeating Austerity*, National Institute Economic Review No. 222 October 2012.

I could elaborate on the ***financial dimension of EMU***. The Banking Union, when completed, has the potential to move up to the highest level of institutional integration. Similarly, the Juncker Plan is a useful integrated instrument, although too weak and slow at present. I have stressed elsewhere the need for and the benefits of moving ahead with a much stronger ***"Financing and Investment Union"***, incorporating these steps forward and going well beyond the proposed Capital Markets Union.



Legend – *SSM: Single Supervisory Mechanism; SRM: Single Resolution Mechanism; CMU: Capital Markets Union; SGP: Stability and Growth Pact; MIP: Macroeconomic Imbalances Procedure.*

Yet, today I prefer to focus on the ***fiscal and structural policy dimensions of EMU***. In practice, our fiscal framework has been implemented as a fairly weak monitoring framework. Likewise, on the structural front, the MIP (Macroeconomic Imbalance Procedure) is clearly lacking teeth. An institution is clearly missing to develop a mandatory and, hence, full coordination of national policies in the fiscal and structural areas, an idea I will elaborate upon in a few moments.

The highly political nature of the debate should not hide the strong economic rationale for such a reform. 15 years ago Peter Kenen[8] argued that a fiscal integration could make currency areas thrive, even though they did not meet all the features of an optimal currency area. To be sure, the highest level of policy integration would logically involve building a genuine fiscal union, as well as completing the Single Market; but that would surely require more ex ante convergence and resolution of legacies from the past. My view is that we should leave the door open to further integration for countries that are willing and ready to consider it. I will come back to it, but first I would like to highlight what I consider to be the most urgently needed part of EMU reform, namely.

[8] Peter Kenen, *Currency unions and policy domains*, Princeton University, November 2000.

II. How to set up a strong institution to fully coordinate national fiscal and structural policies.

This institution is what would enable us to achieve the second level of integration, i.e. full coordination of national policies. In economic terms it would help internalise negative externalities (e.g. demand spillovers, or financial contagion) from asymmetric economic shocks across jurisdictions, as well as optimize positive externalities between fiscal and structural policies. In political terms it would help ***make the Euro area more than the sum of its parts***. Jean Monnet famously declared that "***nothing is possible without men, but nothing lasts without institutions***". I am convinced that ***establishing a strong institution led by a euro area Finance Minister*** would contribute to cement further integration of economic policy.

So let me describe first the mandate and the shared strategy, then the tasks of a euro area Finance minister, and last the way to anchor its legitimacy and capacity.

A. Which mandate and what strategy?

The Commission has already introduced a two-stage European semester, so that the discussion of the outlook for the euro area precedes country-by-country analysis. We must take this further: the ***mandate*** of this decision-making institution must be to achieve the strongest, sustainable and balanced growth. To fulfil the mandate, this institution – in particular the euro area Finance Minister at the head would be tasked to outline the ***collective strategy***. It would be essential for the Euro Area, informed by independent advisory bodies, to collectively agree on overall economic policy objectives, and on the division of tasks through the setting of individual performance targets for Member States. Such an agreement could be reached by a process following more or less the European Semester calendar:

- A ***preparation*** phase would provide the macro framework and take on board individual country contributions, as well as the expertise from the Fiscal and Competitiveness Councils. This phase would require assessing: first, potential growth, with a quantified ambition to raise it; second, the euro area output gap, and employment, taking into account limited cross-border labour mobility; third, the sustainable fiscal and external positions for the euro area as a whole, as well as the sustainable distribution of these positions across countries. There is some similarity with what the G20 has been aiming at with its "Framework for growth", a process through which countries identify shared objectives, the policies needed to reach them, and the progress toward them … although we can obviously be more ambitious for the euro area.
- In a ***decision*** phase, the euro area Finance Minister would propose a strategy, consisting of the collective objective and – as far as necessary – its country specific translations in terms of reforms and policy stance. This proposal would be subject to formal opinions from the Fiscal and Competitiveness Councils. It would then have to be adopted at simple majority by the Eurogroup, and further to be endorsed by the European Parliament. In case of a stalemate, it would be for Heads of States and Governments – the European Council in a euro format – to adopt the collective strategy, on the basis of an adapted proposal by the EA Finance Minister.

We should of course bear in mind the rationale for ***subsidiarity***. Euro area outcomes will remain dependent on national policies. Many areas of policy-making and all implementation will remain decentralised. Yet full coordination will require that economic policy stance and spillovers be collectively agreed upon, and that Member states work consistently to achieve the common objectives.

B. *Which tasks for a euro area Finance Minister?*

First, the Minister would be ***in charge of preparing the euro area-wide collective strategy to fulfill the mandate I already described***.

Second, the Finance Minister would be responsible for ***supervising the implementation of policy objectives and institutional discipline***, using adequate instruments to provide symmetric incentives. Negative incentives would of course include the effective implementation of existing sanction mechanisms. They could be broadened in contractual procedures, already put forward in the 2013 Franco-German contribution on EMU, or in Chancellor Merkel's[9] "binding reform contracts" proposal, and including positive incentives. One of them would be the access to a euro area "Convergence Fund", through which Member States could benefit from common funding, once they have established a track record and convincingly avoided moral hazard. In addition conditioning the participation in economic governance on compliant implementation could provide strong incentives.

Third, the Finance Minister would be responsible for ***implementing centralised crisis management***. The specific features of the ESM set-up shed light on inherent euro area limitations, as Member States decided solidarity would not be part of the usual governance system. As a result, the ESM is grounded in an intergovernmental treaty. A Finance Minister for the euro area would naturally be in charge of overseeing ESM operations. Crisis management methods themselves could surely better integrate debt sustainability, liquidity support, and financial stability, some weak points recently underlined by the IMF.

Last, while moving towards further integration, the Minister could be given the authority for ***managing a Euro area Convergence Fund, evolving towards a Euro budget***. We are touching here on the issue of a common fiscal capacity, promoted recently by Pier Carlo Padoan or Benoît Coeuré. I think it reasonable, as successfully done in the past, to build it in three stages. In the first stage, Member States would be free to join, and the Convergence Fund would be allocated to financing common goods such as European infrastructure investment or refugee settlement. In a second stage that would represent a significant step up, this budget could become a stabilisation instrument, centralising a well-defined set of policy instruments, such as a European layer of unemployment insurance. The third and final stage of fiscal integration would only be achieved if agreement can be found both on financing (direct revenue-raising capacity and common debt issuance) and on the desirable level of business cycle synchronization. As access to this third stage would be linked to reduced risks, this perspective would be a powerful incentive for national discipline and commitment as shown during the march to the Euro.

C. *How to set up a legitimate institution with a genuine administrative capacity?*

Further integration and democratic accountability should progress together, as discussed in my recent article with Jens Weidmann. We need to enable the European economic administration to be more efficient, while establishing strong enough political legitimacy to ensure balance between liability and control. A European Treasury headed by a euro area Finance Minister would have a chance of embodying such a delicate undertaking. These institutional changes obviously require a new Treaty, notwithstanding the "low hanging fruits" we can and must pick up in the coming year.

First, we need a ***legitimacy-enhancing appointment process***. The Finance Minister could thus be appointed for a five-year period by the European Council acting by qualified majority on a proposal from the president of the EU Commission. The new appointment would be subject to the formal approval of the European Parliament, and the Finance Minister would be member of the Commission, as well as chair of the Eurogroup. The Minister would

[9] Angela Merkel's first parliamentary speech of the third term, 18th December 2013.

thereby have the legitimacy to represent internationally the euro area in Economic and Financial fora, alongside the President of the ECB.

Second, the euro area Finance Minister would need to be backed by a ***genuine Treasury administration***, which could include staff from the Commission's Economic and Financial Directorate General, the ESM, and the Economic and Financial Committee Secretariat. Such a civil service would also benefit from the public advice of two independent bodies, the European Fiscal Board and the Competitiveness Council.

Last, if we succeed in implementing further integration, we will need ***stronger democratic control over euro area affairs***. To this end, we will need to consider institutionalising a euro area format of the European Parliament. Relationships between euro area MPs and national parliaments will also need to be enhanced, through an inter-institutional agreement, or by creating dedicated commissions.

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To conclude, let me briefly recap:

(i) ***The lack of economic coordination has a high growth cost for Euro area citizens, of several points of GDP***

(ii) ***Between complete integration – monetary policy type – and solely "monitored" national policies – as at present –, the missing link is a full coordination of fiscal and structural policies***

(iii) ***This full coordination can only be achieved by setting up a legitimate decision-making institution, embodied by a Finance Minister of the euro area, in charge of elaborating its "collective economic strategy".***

Robert Mundell, father of the theory of optimal currency areas, did acknowledge that the euro area was far from optimal. Yet he remained confident, saying: "it will be achieved because, for Europe, it isn't just the best game in town, it's the only game." ***Economic policy as a whole, not central banking alone, is indeed the only game in town***. Of course, we always face the risk of failure when conducting far-reaching reforms. Yet we cannot afford another missed opportunity and we have to act swiftly without losing a longer term view. For EMU, for its citizens, 2016–2017 is the decisive time to act.