Yves Mersch: Dinner speech at EUI-NOMICS

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at EUI-NOMICS, Florence, 24 April 2015.

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Ladies and gentlemen,

The crisis in the euro area has painfully exposed the weaknesses of the euro area's institutional set-up. A lot of progress has since been achieved in making its governance structure more resilient. But further action and reflection are needed.

In theory several ways of further developing this governance structure are conceivable. They range from loose cooperation among Member States to the creation of a federal state; from high levels of discretion to strictly binding rules; and from legitimacy that mainly stems from national elections to legitimacy at the European level that is strong enough to speak of a political union.

I am aware that across this wide range some ideas are politically less feasible than others. And it is up to those democratically legitimised to do so to decide how to adjust the Union's governance structure to best meet the objectives of the EU as enshrined in our treaties.

In my remarks today, I will focus on how the different dimensions of further developing the euro area's governance structure fit together, bearing in mind that they influence each other. These dimensions are:

- First, the method of governance,
- second, the source of legitimacy, and
- third, the decision-making methods.

Getting governance right

In 1992 Europe's heads of state and government committed to creating a monetary union. Sharing a currency implies sharing sovereignty. It requires further integration, including governance structures which go beyond those of a single market which might work based on loose coordination among independent nation states. Striving for supranational solutions in those policy areas that affect the smooth functioning of a monetary union would thus have been the logical consequence of the Maastricht commitment.

But we all know that reality often takes no notice of logic. And we have seen the consequences.

Today, financial policy is more compatible with the requirements of a monetary union than it was at the beginning of the crisis. We now have a European approach to banking supervision and resolution, independent of any national bias. And the creation of a capital markets union will help to better integrate Europe's financial markets.

Obviously, an integrated financial policy is an important complement to a single monetary policy. But economic and fiscal policies also play a crucial role in the smooth operation of a monetary union. Currently, the former are basically dealt with at the Member State level, while the latter is characterised by intergovernmental action without strong supranational control.

This mismatch between one single monetary policy and 19 different, sometimes diverging, economic and fiscal policies has been well diagnosed, but remedying it has proved to be difficult. Decision-makers at times even deviated from the community approach and circumvented the existing European treaties, as this seemed the only way forward. The fiscal compact and the European Stability Mechanism are prominent examples of this purely intergovernmental approach.

The European project has always been characterised by differential integration and this is likely to continue. Current economic and political circumstances suggest that these differences will persist: some Member States will remain unwilling to share more sovereignty, others will want to integrate more, but are not yet able to do so and others still will be both able and willing to move towards a genuine economic and monetary union. In my view, such a combination of “core” countries, “pre-ins” and “opt-outs” can be sustainable, but it has implications for the way decisions are taken and democratically legitimised.

Enhancing democratic legitimacy

Indeed, the main challenge I see in differential integration is the question of democratic accountability.

I assume you all agree that decisions taken at Member State level are characterised by a high degree of input legitimacy. Some may argue that decisions taken at European level enjoy a similar degree of democratic legitimacy: European citizens have the right to choose who represents them in the European Parliament; and the Council draws its legitimacy from national governments and parliaments that are elected by the voters in the Member States.

However, this latter chain of legitimacy in particular is rather long, and the links between a given sovereign act and the will of the electorate is tenuous.

Different degrees of integration further complicate matters. A member of the European Parliament representing a constituency that mandated a government that decided to opt out of the common currency might vote on matters regarding precisely this common currency.

If politicians decide to share more sovereignty at European level, democratic legitimacy certainly will need to be strengthened at that level too. If, however, the EU remains a political system *sui generis* with some Member States being more integrated than others, with some common policy areas being characterised by intergovernmentalism and others by supranational approaches, then we will need to have a commensurately versatile form of democratic legitimacy. The European Parliament could, for instance, assemble in a variety of compositions.

Going for intergovernmental rather than federal solutions thus generates path dependencies. Following the intergovernmental path in monetary policy would have led to the implementation of the UK’s proposal back in 1990 of parallel competing currencies rather than a single currency.

The perceived lack of input legitimacy in the current institutional set-up also implies a high standard of output legitimacy; that is, policy-makers need to generate outcomes that are in the voters’ interest. If they fail to do so, they risk putting the stability of monetary union into question.

Rules versus discretion – a question of space and time?

A monetary union is stable as long as its members find it more beneficial to be in that union rather than outside it. This stability is easier to achieve if everybody plays by the same rules. In a monetary union, economic well-being is not simply a domestic question. Member States’ economies influence each other, which is why a monetary union is more attractive if all its members are prospering.

Accordingly, Europe’s decision-makers have given themselves common rules to guide fiscal and economic policies.

These rules have repeatedly been broken. This suggests that while decision-makers favour a common set of rules to generate trust and credibility among Member States, they have sometimes preferred more flexibility than the rules allow.

In essence, we are facing an issue of time-inconsistent preferences: in the *long* run, governments have an interest in strict rules that foster trust and credibility among Member States. In the *short* run, they might well prefer more discretionary decision-making that allows them to flexibly adapt their policies to circumstances.

In addition, election cycles sometimes encourage myopic policy choices that are not necessarily in the Union's long-term interest. This is especially relevant in the EU's multilevel governance framework with staggered election cycles at the various national and sub-national levels.

I respect that governments are bound by their voters' will. That will might well differ between jurisdictions in general, and between creditors and debtors in particular.

At the same time, I see a risk that governments are making it too easy for themselves when they claim that they cannot make any further concessions at international level because of domestic political pressures.

Survey data shows that an unquestioning belief in opinion polls is not necessarily in the long-term interest of voters. For instance, support for the euro was very low in the Baltic countries prior to the changeover, but it is steadily increasing. In Lithuania net support has increased by 23 percentage points in just one year.[1] Moreover, the European public's initial scepticism about centralised supervision of the banking system has faded away: according to the latest Eurobarometer data[2], 65% of respondents consider central supervision at EU level effective.

This suggests that if politicians want Europe to work for the well-being of its people, they might need to pluck up courage and seek to shape opinion rather than follow it. Should that raise questions of legitimacy, these would need to be addressed by a supranational arbitrator.

I think we can solve the issue of time-inconsistent preferences by simultaneously considering the spatial dimension of decision making: if decisions of common interest are taken at *national* level, rigid rules that leave no room for interpretation are needed to create a level playing field. If decisions are taken at *supranational* level, more flexible regulation is possible without creating distortions.

Supranational institutions can overcome the time inconsistency: they have credibility, as they are bound by a mandate; and they can react to changing circumstances as they have flexibility in the decisions they take within this mandate.

In the EU, we already partly take advantage of this approach: the Commission has executive powers on competition policy and the ECB has executive powers on monetary policy and – since November last year – on the supervision of banks. I dare to add that in those areas where European institutions have been granted executive powers and a clear mandate, they use them reasonably well.

When supranational institutions are assigned conflicting tasks, assessments of their performance become less clear-cut. Recent decisions by the European Commission on the Stability and Growth Pact (SGP) and on the macroeconomic imbalance procedure (MIP) are a case in point.

In relation to the SGP, the Commission decided, in late February:

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1 Standard Eurobarometer 81 and 82, http://ec.europa.eu/public_opinion/archives/eb_arch_en.htm.

2 http://ec.europa.eu/public_opinion/archives/eb/eb82/eb82_en.htm.

- not to step up the excessive deficit procedure (EDP) for France and to extend the EDP deadline for that country by another two years, to 2017;
- not to open a debt-based EDP for Italy and Belgium;
- not to issue autonomous recommendations for Spain and Portugal, in contrast to what the previous Commission had decided for France and Slovenia in March 2014 under comparable circumstances.

On the MIP, the Commission decided:

- that France, Croatia, Portugal, Italy and Bulgaria have excessive imbalances, which require specific monitoring and decisive policy action.
- not to propose the activation of an excessive imbalance procedure (EIP) for any country, but the Commission did leave the door open to activate an EIP for France and Croatia in May.

These non-decisions might weaken the corrective arm of the Pact and undermine the debt rule. Moreover, they cast doubt on whether the governance framework can still play its role as anchor for confidence. One of the major lessons of the first ten years of Economic and Monetary Union, and reflected in the 2011 reforms was to avoid repeating the mistake of not implementing the framework when it affects large countries. The Commission might find itself increasingly torn between being a political actor on the one hand and the guardian of the Treaties on the other.

Conclusion

Granting more executive powers to the European level in the economic and fiscal realm might be the way forward. But it would require changing the treaties of the European Union. Currently, I see little political will for such a move.

This makes it even more important to strictly apply and enforce existing rules and instruments that are meant to act as anchors of confidence, such as the Stability and Growth Pact and the macroeconomic imbalance procedure.

The guardian of the treaties has to perform a difficult balancing act in following its desire to act as a quasi-government and at the same time enforcing common rules. Striking a balance between desire and duty can only work if there is a prospect that its mandated duty is adjusted to fit its desire.