



Coming of Age

Report on the euro area, January 2008

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- **Why revisit the EMU policy system?**
- **Our approach**
- **Key recommendations**
 - Monetary policy
 - Fiscal policies
 - Structural reforms
 - Financial stability
 - Enlargement
 - External dimension
 - Governance
- **Does it require changing the treaty?**



Why revisit the EMU policy system?

- **“If it isn’t broken, don’t fix it”**
EMU isn’t broken – on the contrary it’s a success. But
- **Economic performance has been disappointing**
 - Macro performance acceptable only despite favourable world environment
 - Divergence within euro area
 - Governments often seem to ignore what EMU implies
- **Enduring discussions on governance**
 - Almunia, Juncker, Sarkozy
 - Participants live together but dream separately
- **The context has changed**
 - Our economies have changed - financial instability
 - Europe has changed - enlargement
 - The world has changed – China



Our approach

Start from what is to be expected from a policy system

Stability

- Major asset
- Room for broadening the concept

Predictability

- Important is what is bound to remain a decentralised policy system
- More to do - mostly governments, but ECB has leadership

Incentive properties

- EMU can help improving the quality of economic policies

Adaptability

- Faithfulness to past agreements not a justification for ignoring new challenges

Overall, important to **learn from experience**

- EMU constitution embodied the best practices from the 1980s, but we need a state-of-the-art EMU, this requires permanent learning
- There has been learning – ECB strategy adjustment '03, SGP reform '05, more is needed



Recommendations – **monetary policy**

- **Our assessment: Much to praise. But:**
 - As the pan-European macroeconomic player ECB has decisive leadership role in shaping expectations
 - Need to improve relationship with governments. One cannot be satisfied by childish controversies on interest rates
- **2 proposals to the ECB to improve predictability**
 - **Full inflation targeting** with symmetric band around 2%
 - Forecast to **reflect the views of the Governing Council**
- **1 proposal to the Eurogroup**
 - Eurogroup should **endorse and publicly support** the 2% target
 - Would help narrowing down the scope for controversies



Recommendations – **fiscal policies**

- **Agreement on what is desirable – discipline and stabilisation. Question is why it is not achieved**
- **Our assessment**
 - Effectiveness of common rules is very uneven
 - Way forward is to **decentralise fiscal discipline**
 - Room for joint initiative in exceptional circumstances
- **Main proposals**
 - Continue shifting emphasis from deficit to **comprehensive concept of debt sustainability**
 - More fiscal autonomy to countries with **home-grown fiscal discipline**
 - Recognise that **good institutions may differ** from one country to another
 - Eurogroup: strategic thinking, common guidelines in situations of **stress**



Recommendations – structural reforms

- **Our assessment**

- Contrary to expectations, euro has not accelerated the pace of reforms – anaesthetic effect?
- Euro area remains more regulated than competitors
- Reforms vital to ensure proper functioning of euro area

- **Main proposals**

- Better carrots: foster learning and strengthen **incentives** through independent assessment, Commission surveillance, EU budget support to reforms
- If trade-off between reform and fiscal adjustment arises (should be rare), require **time-bound commitment to debt ratio**



Recommendations – **financial stability**

- **Our assessment**

- Euro has given a boost to financial integration, including cross-border bank M&As
- But supervision remains fragmented
- Governance by committees unlikely to be adequate in case of failure of a pan-European bank

- **Proposal**

- **European prudential and supervisory regime for pan-European banks**



Recommendations - enlargement

▪ Our assessment:

- Low economic rationale, high political risk in current approach Maastricht criteria were designed for a different situation.
- For the NMS, there are both reasons for (integration, avoidance of sudden stops) and against (need for real exchange rate adjustments) joining early
- Fixers face more difficulty in reducing inflation than floaters

▪ Main proposals

- **Amend/reinterpret the inflation criterion** (euro area inflation + 1.5%)
- **Scrap the obligation of ERM2** membership
- **Tighten the fiscal criteria** : stricter debt criterion, NMS should aim at surpluses during fast-growth years
- No softening, but **quid-pro-quo**



Recommendations – external dimension

- **Our assessment**

- Open disagreements nullify attempts at talking to markets
- World has changed: Implicit treaty reference to target zones now irrelevant, issue of currency regime in RoW (China) has emerged

- **Main proposals**

- **No need to overhaul current assignment of responsibilities**
Grey zone between ECB and EG to remain

But:

- Need for **verbal discipline**
- Need for **streamlining of external representation – including single IMF chair**



Recommendations - **governance**

▪ **Our assessment**

- System rests on:
 - Rules to safeguard stability (regime preservation)
 - Incentives to promote good policies (policy improvement)
 - Coordination to address unpredictable situations (residual mode)
- Appropriate regime for decentralised system, but scope too much reliance on procedure, too few incentives, scope for regime preservation too narrow

▪ **Main proposals**

- Clarification of role of EG vis-à-vis ECOFIN desirable
- **Heads of state meetings** in euro format, if only to remind them that they have joint responsibility in its success
- **Less procedures, more ability to address risks** to the functioning of the euro area (political agreement to put weight behind formal recommendations)



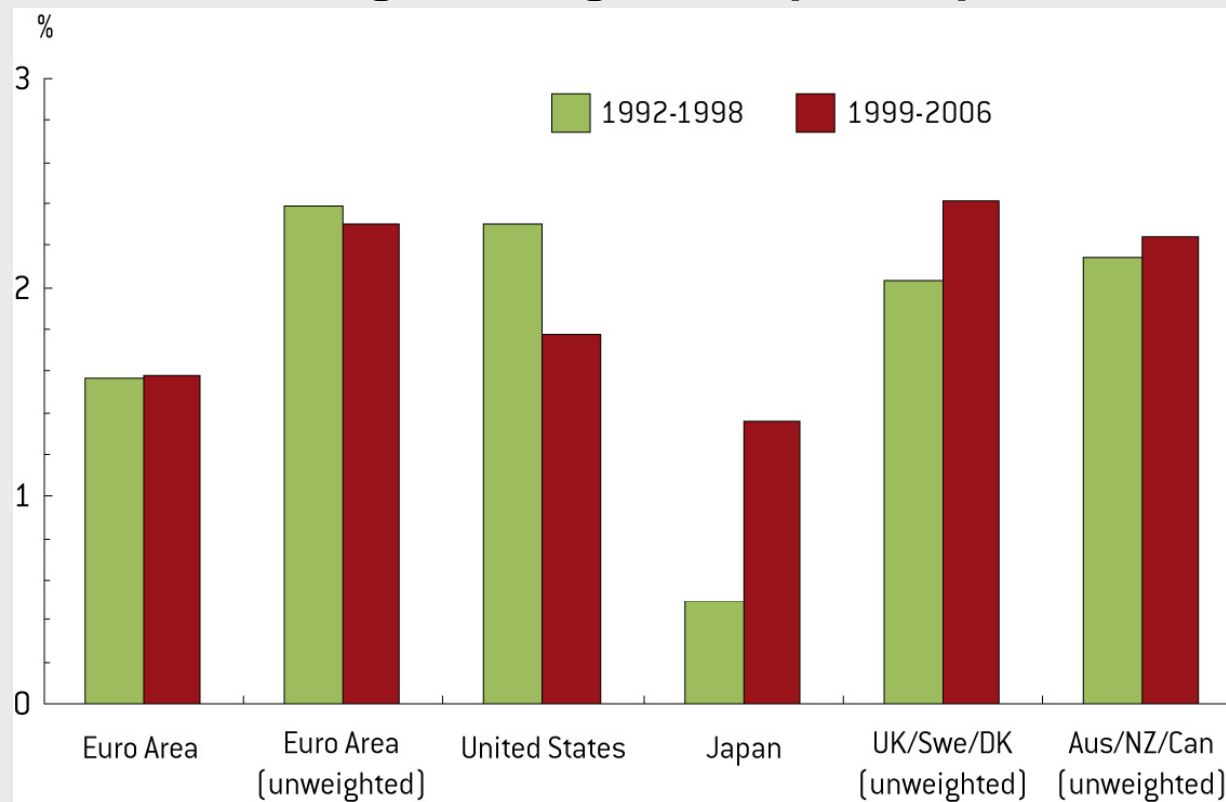
Does it require changing the treaty?

- **No in general**
 - More need for sound reasoning than for new rules
 - Amendments can be introduced through secondary legislation
 - Ultimately could be translated into treaty changes
- **Enlargement specific issue**
 - Treaty provisions for entry criteria have been interpreted narrowly
 - Reversible?



Macroeconomic performance

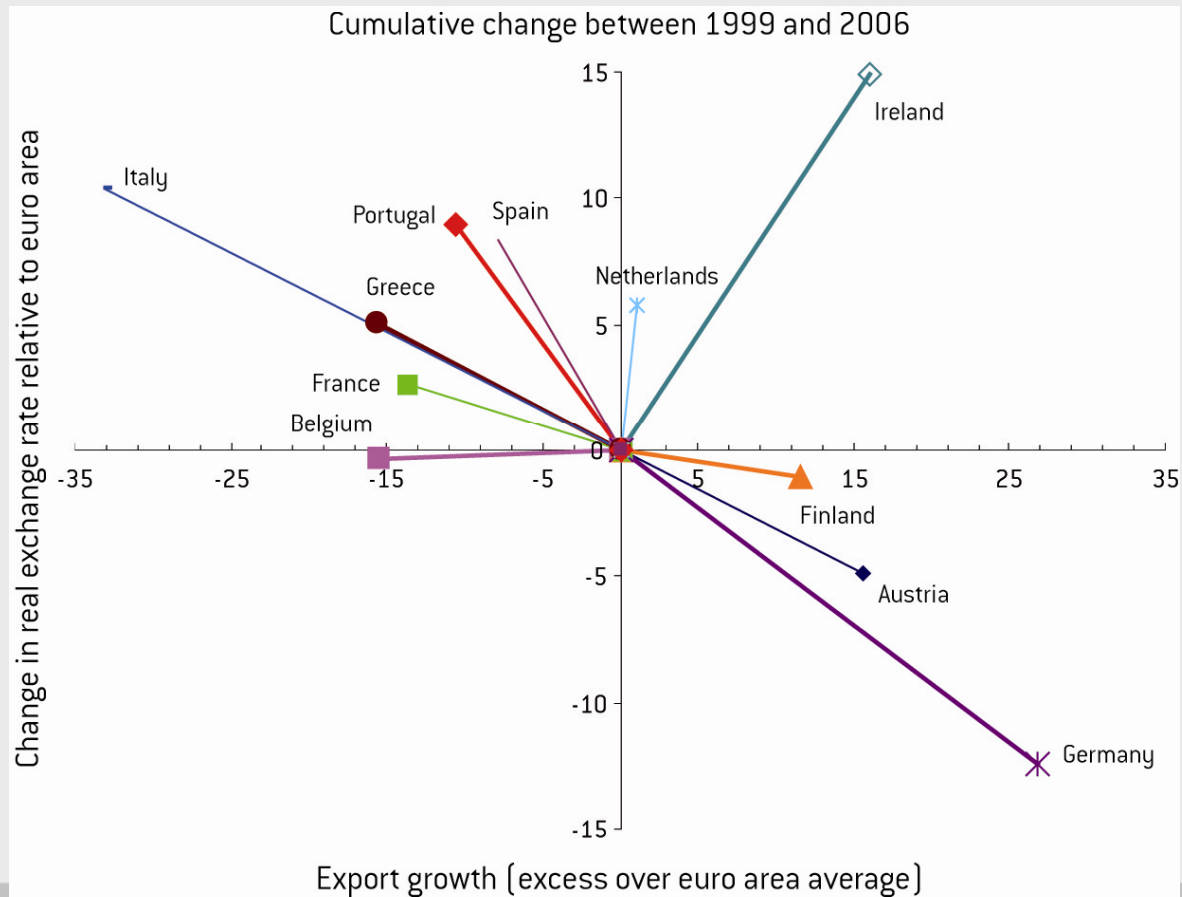
Average GDP growth per capita





Competitiveness divergence

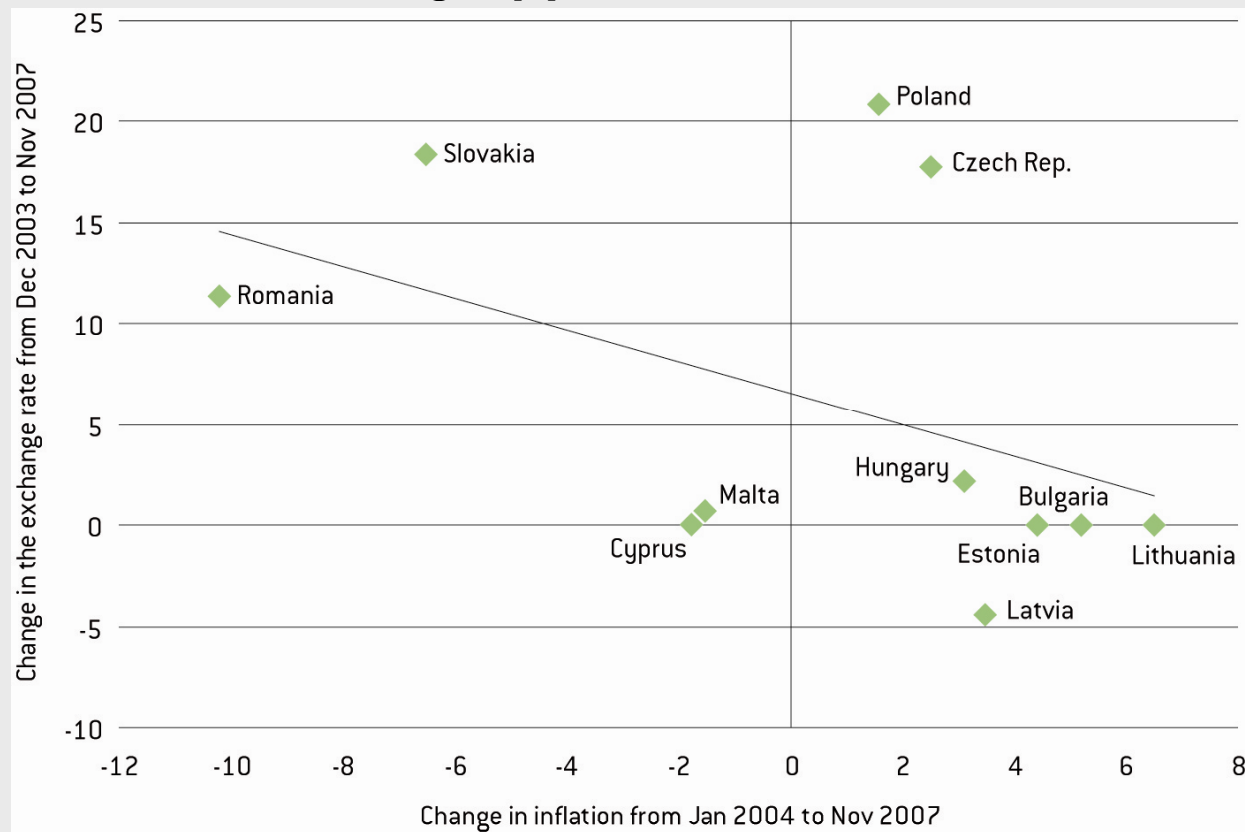
Chart 2.8: Real exchange rate and relative export performance





NMS: Exchange rate and inflation

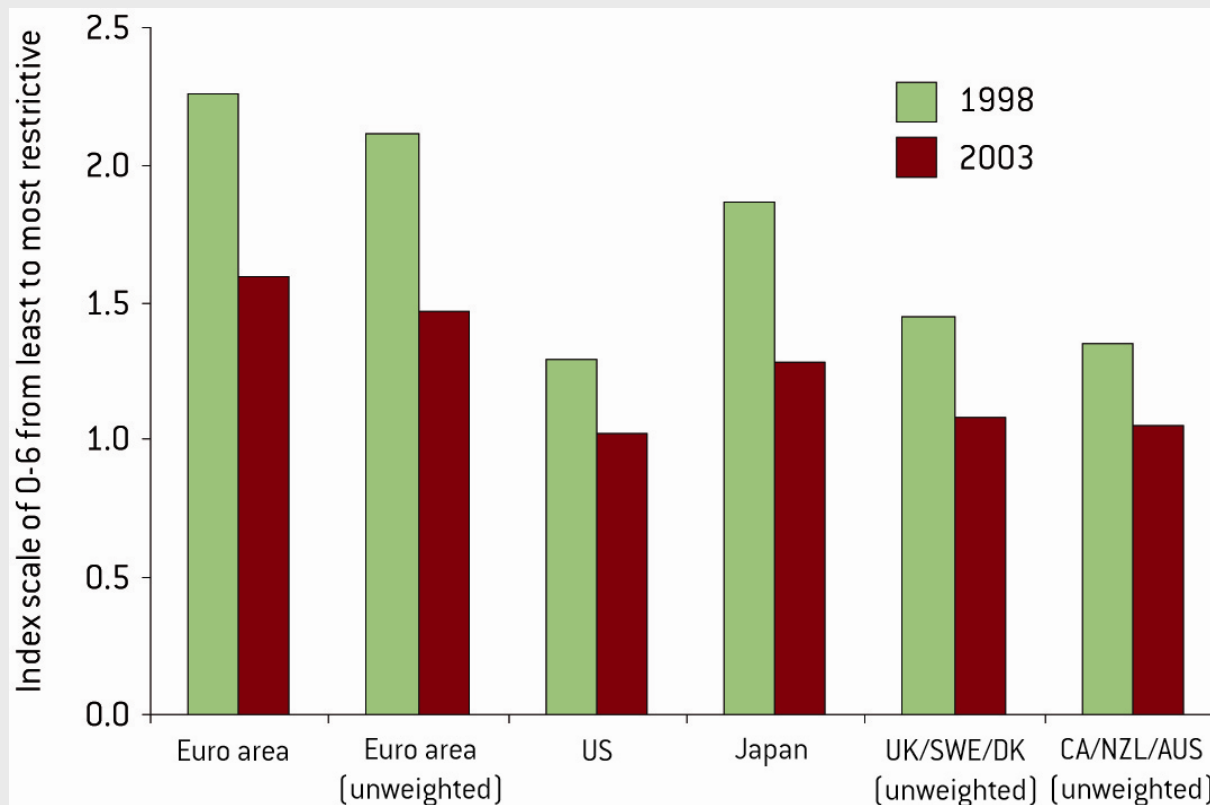
Nominal Currency appreciation and disinflation





Product market regulation

Indicator of product market regulation





Thank You For Your Attention

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