EMU GOVERNANCE AND THE MEMBER STATES: LESSONS FROM FEDERATIONS AND OTHER COUNTRIES

Cinzia Alcidi
Head of Economic Policy Unit, Centre for European Policy Studies (CEPS)
cinzia.alcidi@ceps.eu

Introduction: An overview of EMU governance

It could be argued that the original institutional setting for the Economic and Monetary Union (EMU) was based on three pillars. The first one is centralised monetary policy. Competences for monetary and exchange rate policies were moved from the national to the central level and attributed to the European Central Bank. One key assumption of this construction was that by imposing a narrow central bank mandate for price stability, financial stability would ensue as a by-product. In the 1990s, there was quite a broad consensus among economists that this would happen, driven by financial liberalisation and market efficiency.[1] The assumption seemed to be validated by the experience of great moderation, but did not last very long. The paradigm explains why financial stability was never explicitly taken into consideration in the EMU model.

The second pillar of the EMU model is a decentralised but constrained fiscal policy. Competences for budgetary policy remain the responsibility of national governments, but are limited. The Maastricht Treaty (1992) embeds the commitment of member states to limit fiscal policy discretion by adopting a framework based on common fiscal rules: the Stability and Growth Pact (SGP). National governments can still choose the tools and specific policy actions, but numerical targets have to be met, substantially reducing the room for action. The purpose of the rules is, *ex ante*, to ensure a prudent and disciplined fiscal policy. This is key to the achievement of a threefold objective: a) to reduce the occurrence of shocks at national level induced by fiscal policy that cannot be absorbed by monetary policy, which is set in response to average and not country conditions; b) to reduce the risk of negative cross- country spillover effects; and, c) to avoid any impaired transmission of monetary policy. The "no bail-out" rule included in the treaty was expected to make the rules credible and to ensure their enforcement.

The third pillar of the EMU model relates to the structure of the economy. Growing trade in goods and services, driven by the single currency and the completion of the single market, was expected to

1. See Borio and White (2004) for a different viewpoint. They argue that price stability can create a favourable environment for financial instability and inaction on the part of central banks.

boost growth and convergence among countries. The mobility of labour and capital, combined with (a certain degree of) flexibility of prices and wages was expected to provide the mechanism to absorb asymmetric shocks.

From a conceptual point of view, this framework relies heavily on the optimum currency area theory (Mundell, 1961), which was adapted to the European context where fiscal union does not exist. Despite the violation of the SGP in 2004-05 by Germany and France, which back then proved the limits of the framework, it remained unchanged until 2010. The outbreak of the crisis started a broad debate about the appropriateness of the fiscal framework and even of the EMU model. The first response consisted of reinforcing the governance framework by enhancing economic policy coordination. This resulted in a new SGP. On the fiscal side, the approach was clearly to maintain and reinforce the existing rule-based system by developing stronger surveillance mechanisms on a country-by-country basis and through a wider spectrum of semi-automatic sanctions.

These innovations were accompanied by a wide range of changes in the regulation of the financial sector and of the banking sector in particular, as well as supervision and monitoring of financial stability and systemic risks. The creation of the European Stability Mechanism (ESM), a permanent crisis management instrument for safeguarding financial stability in the euro area, demonstrates the explicit recognition that financial instability can occur even if price stability is preserved, that this instability can fundamentally threaten the functioning and even the existence of the EMU and that safety net mechanisms are necessary.

Overall, the crisis brought significant changes to the governance system but the original idea, whereby constrained fiscal policy stays under national sovereignty, remains a key pillar of the EMU framework. Five years after the introduction of the reformed fiscal governance framework, the assessment of its ability to deliver greater fiscal stability is far from being unanimously positive. Rules seem to be binding only during times of recession, and in some cases have resulted in pro-cyclical budgetary policies which amplify the recession. Against this background, in more recent times the European Commission's approach has consisted of reasserting the need for more policy coordination and, above all, a move towards a flexible interpretation of the rules.[2]

In fact both flexibility and coordination raise certain questions. First, a flexible interpretation of the rules implies some degree of judgement in the assessment, which confers a political character on the commission's decisions. The European Commission was not designed as a political institution.[3] This is a new feature that is meant to make rules "less stupid",[4] but which in fact undermines their value and credibility.

Second, it is unclear whether policy coordination always leads to a better outcome. Economic literature on the topic is ambiguous and fails to consider how gains from coordination may vary according to the state of the economy.[5] Furthermore, economic policy coordination has significant limits of political and economic nature. The incentives for each country to coordinate their policies with other countries ultimately rely on expected gains from abandoning choices driven only by domestic considerations in favour of coordinated action. Yet gains are unknown as well as uncertain

2. See EC communication of January 2015 http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf.
3. Traditionally, the European Commission is known as "the guardian of the Treaties" and its role is to defend the interests of the European Union while remaining politically neutral.
4. In 2002, Romano Prodi, then president of the European Commission, called the Stability Pact "stupid" because of its rigidity; he had already called for a more intelligent and flexible tool.
5. See Alcidi et al. (2015) for an overview of the literature on fiscal spillover effects.

and take time to materialise. By contrast, the costs (both political and economic) of coordination can materialise in the short term and be very high. Another problem of coordination is that its objective, i.e. the welfare of the eurozone, is not explicitly stated anywhere. The specific experiences of Greece and Germany can be taken as two examples of how difficult and costly coordination is. The three adjustment programmes imposed on Greece, which can be seen as extreme cases of policy coordination, clearly aimed at achieving important broad goals for the eurozone as a whole: to prevent the Greek crisis from spilling over into other countries and ultimately leading to the breakup of the EU. Coordination was forced and achieved in exchange for financial support. In more recent times, the commission and many commentators have argued that given its large current account surplus, Germany should move to a more expansionary fiscal stance. Beyond the stimulus this would give to the domestic economy, the implicit objective for the eurozone as a whole is that it could generate positive spillover effects in the other economies of the region and make it easier for debtor countries to recover.

The two examples suggest that while the existence of cross-country spillover effects (positive or negative) is the fundamental reason for coordination, the specific objectives of policy coordination can be different. They also show that national interest, or the perception of it, may not be aligned with the common interest of reducing or preventing spillover effects. Greece, by losing its creditworthiness, was losing its sovereignty and had little choice but to accept the programmes, and hence coordinate for the good of the union. By contrast, Germany, which is fully sovereign, is setting its policies according to domestic considerations.[6]

Another aspect that makes coordination difficult to achieve relates to legitimacy (Begg, 2015). Economic policy coordination, which in the EU framework includes both fiscal rules and member states' cooperation in response to shocks, works as a constraint on the discretion of national governments when setting economic policy that goes beyond the political term. This raises issues of legitimacy (Alcidi et al., 2014). In certain circumstances, the electorate can manifest its opposition to the implications of such commitments (generating a problem of time inconsistency). The Greek referendum in the summer of 2015 can be seen as a manifestation of this problem. A German, Finnish or Dutch referendum on whether to approve financial support to Greece, or any other country in trouble, would be a manifestation of the same problem.

This may even raise the question of whether the EMU is compatible with the principle of democratic legitimacy.

The broad arguments illustrated above, all lead to the conclusion that economic policy coordination, while desirable under certain circumstances, seems to have worked only partially and entails major problems. This raises the old question of whether the EMU needs a different form of governance, in particular to move from a system based on rules to one based on institutions.

This "solution" itself poses many questions about the optimal institutional design and the objectives that can and should be achieved, but above all, about how national sovereignty on budgetary policy should be relinquished in favour of central EMU governance.[7] Without going into

6. If, in the end, a German stimulus materialises it will be because it was chosen as the response to the refugee crisis, and not necessarily to support weak demand in the euro area.
7. One intermediate solution is that some resources are centralised for specific stabilisation purposes, for example, a common European unemployment benefit scheme, to which the Five Presidents' Report refers.

detail, many have argued that a fiscal union would resolve all eurozone problems and that had one been in place in 2010 many problems would have been prevented from emerging. The Five Presidents' Report makes explicit reference to fiscal union as a future objective.[8]

This short paper attempts to show that while fiscal union is certainly desirable from an institutional/legitimacy point of view, and would be much more effective than coordination in addressing certain problems, it should not be thought of as the solution to all EMU problems.

In particular it would be a mistake to believe that such a union would solve fundamental problems in countries like Greece where the crisis really erupted and where it is more difficult to be overcome. To make the case for this idea I look into the experience of regions with characteristics comparable to those of Greece that are part of nation-states or federal states that are full fiscal unions. In particular, I look at the features and the historical experience of the Italian Mezzogiorno as part of Italy and the more recent experience of Puerto Rico as part of the United States. Of course it should be kept in mind that the Mezzogiorno is a set of administrative regions within Italy and Puerto Rico is a protectorate of the US, hence the position of each differs from the one Greece could have as part of a future European fiscal union. Yet, as will be shown below, Greece, the Mezzogiorno and Puerto Rico share important economic and institutional features and the way fiscal transfers from Italy and the US have worked in the Mezzogiorno and Puerto Rico, respectively, provide interesting insights on how fiscal transfers from the EMU could work in Greece.

Will fiscal union tackle the problems of the EMU?

Fiscal union is often advocated as a necessary step to address the fundamental problems of the eurozone. There is a certain consensus that, had monetary union also been a fiscal union, the crisis would have played out differently and not had the features and the magnitude observed since 2010. This view is founded on two main arguments, the first of which is based on the experience of the US. The US is a fully-fledged federation with economic, banking and fiscal union, which is undeniably a benchmark for future institutional developments for the EMU, and did not experience the kind of existential crisis that occurred in the EMU. This was the case even though some US states, such as Florida and Nevada, had real estate bubbles and bursts comparable to those of Ireland or Spain (Gros and Belke, 2015), California has been at risk of sovereign default for a decade (since 2004) and Puerto Rico defaulted in 2015 (Gros, 2015).

The second argument is based on the idea that monetary union must be complemented by fiscal union. The combination of multiple national fiscal policies with a single monetary policy is unsustainable, so in order to manage macroeconomic imbalances a federal structure that oversees revenue collection and expenditure is necessary. Without it, the euro will always be vulnerable to shocks. A fiscal union with proper democratic oversight will give the union strength and stability, mutualising credit risk while imposing tough fiscal discipline.

While both arguments are tenable, it is a mistake to believe that even such a fundamental change could resolve the deep-rooted and structural problems

8. http://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf.

of some of the EMU member states. More specifically, even if Greece were part of the fiscal union, it is unlikely that some of its fundamental characteristics would change. This is what other experiences suggest.

Local economics and institutions matter[9]

Greece, southern Italy and Puerto Rico: three tales, one plot

By the standards of small economies, Greece's is surprisingly closed. According to estimates by Bower et al. (2014), Greece exports about one-third less than a gravity trade model based on GDP, trading partners and distances would predict. In reality, Greek exports are even lower if one excludes those that do not entail significant value added.[10] As a share of GDP, the "adjusted" exports of goods amount to less than 10%. Such a small value means it is easy for exports of services to be larger than those of goods, which is a very rare phenomenon for any country. Such a low degree of openness is even more puzzling if we consider that Greece joined the EU more than three decades ago and the EMU 15 years ago. The single market and the single currency have failed to integrate Greece into the EU regional economy both in terms of trade and participation in the global value chain. In fact, such a disappointing outcome is not unique in Europe.

Table 1, which shows the data for different aggregates of Italian regions, suggests that the exports of goods as a share of GDP in the southern regions of Italy and its islands, the Mezzogiorno, are of exactly the same order of magnitude as Greece's and markedly lower than those in the north of Italy. Moreover, there has been no improvement since the start of the crisis.

Table 1. Goods exports as a percentage of GDP in Italy, 2011-14

	South & islands	Northwest Italy	Northeast Italy
2011	10.6	27.8	31.8
2014	10.1	29.8	34.7

Source: Alcidi et al. (2015) based on ISTAT.

Limited export capacity is not the only unusual economic feature for a long-standing member state like Greece or a large region (like the Mezzogiorno). Both Greece and the Mezzogiorno have always been characterised by:

- Low female participation in the labour force (according to Eurostat, in 2014 it was 59% in Greece and only 40% in the south of Italy);
- High youth employment rates (52% in Greece and 56% in southern Italy);
- A large share of public sector employment (23% in Greece and 24% in southern Italy);
- A small manufacturing base; 8% of GDP in Greece (according to the World Bank) and 7.9% for the Mezzogiorno (according to the SVIMEZ report for 2015), whereas in northern Italy it is close to 18%;
- Low competitiveness in the manufacturing sector and small and micro-enterprises active in the low-valued added and non-traded sectors;
- Local systems and institutions that tolerate a large share of irregular and informal activity.

9. For a more detailed comparison of Greece and the Mezzogiorno, see Alcidi et al., (2016).
10. This is quite substantial given that the largest share of goods exports in Greece is fuel and Greece is not a commodity producer.

Such an economic structure is inevitably both the cause and the consequence of pervasive low productivity. Areas with these features inevitably exhibit a low degree of development and low standards of living. In some cases, however, (at least for certain periods) GDP and employment growth have been made dependent on externally funded domestic demand. When this is possible, consumption patterns become independent of the capacity of an area to produce and generate income. This results in higher standards of living that distort price and wage formation mechanisms which, in turn, do not reflect productivity and are unresponsive to market changes. From this perspective, Greece and the Italian Mezzogiorno are different yet very similar.

Since the 1970s – and still today – the Mezzogiorno has benefitted from automatic transfer mechanisms from central government. Over time this system has constituted a political commitment at national level to support the poorest regions of the country. This has resulted in substantial and de facto permanent transfers, often complemented by "extraordinary interventions" by the state, such as investment and development plans that aim to reduce the divergence between north and south.[11] According to data from the Italian Ministry of Economy and Finance, total transfers from central government to the regions (net of social security) amount to more than 20% of local GDP annually.

Because of the inexistence of a fiscal union at eurozone level and the absence of any sort of fiscal transfers from the central level to member states, Greece has never benefited from such a system. However, Greece has been a net recipient of non-negligible amounts of (structural and cohesion) funds from the EU budget. In the early years of EU accession, they amounted to as much as 4-6% of GDP, while after 2001 and accession to the EMU they fell to about 2% of GDP. While EMU membership reduced access to EU "public" funds, it substantially boosted access to private funds. Since the early 2000s and for about a decade Greece benefited from very large inflows of capital channelled by the banking sector. Resources were allocated mainly in the public sector, to finance consumption directly and indirectly, and in the real estate sector, which experienced a small bubble. But, essentially, these funds did not generate any future income capacity. When the crisis started, Greece experienced a classic sudden stop of lending and capital flows ceased abruptly. By that time external debt had reached almost 200% of GDP in gross terms and 100% in net terms. Sudden stops usually force sharp, painful adjustment because consumption (and imports) has to adapt to limited domestically generated income. This is the case unless large external support is provided. The various EU (and IMF) emergency support plans aimed to contain the cost of the adjustment, but a certain degree of correction is unavoidable unless a permanent system of transfers is put in place.

It should be noted that in an economic environment of low productivity and openness, internal devaluation – i.e. the falling prices and wages that usually follow the sudden stop – does not necessarily lead to higher exports and GDP. Since external demand is not providing any offset, the most likely and dominant effect of devaluation is the fall in domestic demand, and given its large weight in aggregate demand, in output. Such dynamics can help explain why the first two adjustment programmes for Greece led to a huge fall in GDP, even if wages fell by over 20% in absolute terms.

11. Between 1950 and 1984, the Cassa del Mezzogiorno, a public body with large administrative autonomy, was active in funding industrial development in the south of Italy, with an explicit mandate to contribute to closing the gap between north and south. The disappointing results, largely imputed to inefficiencies at various levels (from the public administration to the legality and security conditions of workers) combined with dispersion and non-transparent use of funds led to the closure of the institution. In the following years, interventions were based on common and pre-defined objective criteria.

Another important element common to both Greece and the Mezzogiorno is that, with all due exceptions, in both areas public institutions have tended to be weaker, corruption more prevalent and the public administration relatively more inefficient than in other European regions. If this is combined with the evidence that easy access to money from external sources usually tends to reduce the interest of the population in exerting control over how money is spent, transfers, either public or private, fail to produce the expected results. Even worse, in the Mezzogiorno welfare state provisions have often been abused and used to entrench political clientelism. Such considerations seem to support the view that transplanting welfare systems and transfer mechanisms conceived for regions with strong social capital into regions with poor social capital can lead to very perverse effects.

Along with the Mezzogiorno there is another case that could be taken as a benchmark for understanding what one can and should expect from fiscal union and its limits when it comes to structural problems, both economic and institutional.

This case is Puerto Rico. The state, part of the Commonwealth of the United States, became famous, or rather infamous, in 2015 for its default. As explained in detail in Gros (2015), the country is not formally a US state but can, de facto, be fully assimilated into it. Indeed, Puerto Rico uses the dollar as currency and benefits from two key elements of the US fiscal union: transfers from the federal budget to the local budget and transfers from federal programmes directly to individuals.

The experience of Puerto Rico suggests that being part of a fully-fledged federation with monetary and fiscal union is not a sufficient condition for convergence, or even enough to avoid default. The table below depicts a few basic indicators of the economic structure of Puerto Rico, Greece and southern Italy and compares each of them to the union to which they belong: the US, the EMU and Italy, respectively.

Table 1. Comparing Puerto Rico, Greece and the Mezzogiorno

	Puerto Rico		*Greece*		*South of Italy*	
		Relative to US		Relative to EU		Relative to IT
GDP per capita (USD for US and euro for Greece and Italy)	19,801	0.43	16,500	0.56	17,100	0.6
Wages/week (USD for US and euro for Greece and Italy)	390	0.52	458	0.64	583	0.9
Employment rate	35.0	0.76	49.4	0.77	41.9	0.8
Unemployment Rate	13.9	2.48	26.5	2.28	20.4	1.6
Poverty Rate	45.4	3.13	36	1.53	43.4	1.8
	WGI Corruption		European Quality of Government Index (EQI)*			
Governance	0.5	1.3 (level for US)	-0.96	n.a.	-1.62	-1.06 (level for IT)

* Indicator based on survey data on corruption and governance at regional level within the EU, Charron et al. (2015)
Source: For Puerto Rico, based on Gros (2015), the Commonwealth of Puerto Rico, US Bureau of Labour Statistics and World Bank; forItaly, based on Eurostat and Istat; for Greece and the EU based on Eurostat, . Latest data available in all cases.

Quite stunning similarities emerge between the three areas when they are compared to the average level of the union to which they belong: low income, high unemployment and low quality of institutions, both in absolute and relative terms. One difference relates to wages: In the Mezzogiorno the ratio of regional to national wages is much higher than in the other areas. This is explained by the fact that the wage bargaining process in Italy is mainly centralised at national level, and negotiated wages are applied throughout the country regardless of productivity and unemployment differentials across the regions. The problem of the same wages but different productivity and development is exacerbated by being denominated in the same currency. This is different from the situation of Greece in the EMU, where no cartelised bargaining system exists.

When it comes to employment, unemployment and poverty, each of the three areas exhibit quite similar rates. The indicators of quality of governance, while not comparable across the areas, suggest that all three areas exhibit very low standards.

In Puerto Rico, the World Governance Index value is far below that of the US, but better than those of Italy and Greece. In EU countries and regions, governance and corruption can be compared through the EQI (the EU Quality of Government Index), which ranks EU regions and countries. According to the 2013 survey not only Greece, Italy and the Mezzogiorno exhibited negative signs, suggesting low quality, but Greece is 158th and Italy 174th out of the 199 countries and regions listed. The Italian administrative regions of the Mezzogiorno all rank above 180, with only part of Bulgaria doing worse.

All in all, while differences among the three areas exist and parallels should neither be stretched too far nor abused by populist discourses, the discussion is worth having.

Conclusions

The attempt to strengthen economic policy coordination and the more flexible approach to rules that followed the crisis both highlighted the limits of the current system of EMU governance. The rules do not work in times of crisis and discretion requires a political government, which is missing at EMU level. In this respect there is little doubt that fiscal union could improve the functioning and legitimacy of the union. However, the experience of other countries and regions that are part of fiscal unions suggests that fiscal union alone is not a panacea.

The historical experience of the Mezzogiorno, which shares many similarities with Greece, both in terms of economic structure and institutional features, suggests that being part of a fully-fledged fiscal, monetary and banking union like Italy protected the region from the dynamics of global financial markets, unlike what happened to Greece. However, the very existence and persistence of such similarities suggests that this was not enough to remove its structural weaknesses. Puerto Rico also has similarities with Greece, and being part of a fully-fledged federation like the US was not enough to ensure convergence to US standards or to avoid a default on international lenders.

Overall the experiences of the Mezzogiorno and Puerto Rico, as well as also other lagging regions in Spain and even Germany, point to the fact that a fiscal union can be a powerful tool for macroeconomic stabilisation but structural problems are much more difficult to solve. On the contrary, it can even induce perverse effects. Transfer mechanisms from the centre aiming at closing development gaps across regions can only work if strong social capital exists in the region. Building it may require institutional and cultural transformations. These can be induced by the establishment of private and public incentives towards reforms and changes in the values and beliefs systems. The starting point is certainly the acceptance of the need to explore the deep roots of contingent and recurrent problems which means avoiding the search for scapegoats and learning to reject what Robert Hughes refers to as the "culture of complaint".

References

Alcidi, C., A. Giovannini and S. Piedrafita, "Enhancing the legitimacy of the EMU", study commissioned by the European Parliament, 2014, available at: http://www.europarl.europa.eu/RegData/etudes/STUD/2014/536312/IPOL_STU%282014%29536312_EN.pdf.

Alcidi C., N. Määttänen and G. Thirion, "Cross-Country Spillover Effects and Fiscal Policy Coordination in EMU", *FIRSTRUN Working Document*, 2015, available at: http://www.firstrun.eu/files/2015/12/D1.1_literature_review.pdf.

Alcidi, C., L. Bonatti and A. Fracasso, "The Greek crisis and its structural features: some insights from a comparative exercise", forthcoming, 2016.

Begg I. "The European Expenditory State: an emerging mode of economic governance?" *FIRSTRUN Working Document*, 2015, available at:
http://www.firstrun.eu/files/2015/12/D6.1_European_expenditory_state.pdf.

Borio, C. and W. White, "Whither monetary and financial stability? The implications of evolving policy regimes", *BIS Working Paper 147*, 2004.

Charron, N, L. Dijkstra and V. Lapuente, "Mapping the Regional Divide in Europe: A Measure for Assessing Quality of Government in 206 European Regions", *Social Indicators Research,* 2015, vol. 122 (2): 315-346.

Gros D., "Puerto Rico and Greece: A tale of two defaults in a monetary union", 2015, available at: https://www.ceps.eu/publications/puerto-rico-and-greece-tale-two-defaults-monetary-union.

Gros D. and A. Belke, "Banking Union as a Shock Absorber: Lessons for the Eurozone from the US", Rowman & Littlefield International / CEPS, 2015.

Hughes, R., *Culture of Complaint: The Fraying of America*, New York: Oxford University Press, 1993.

Mundell R., "A theory of optimum currency areas", American Economic Review, 1961, vol. 51, issue 4, pp. 657-665.