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Commentary

A stronger, growth-oriented surveillance for EMU

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The Greek crisis has raised doubts about the sustainability of European Monetary Union. Greece has taken significant adjustment measures. The Eurogroup decision to provide financial support if necessary goes in the right direction. However, such measures may not be enough to deal with the risk of instability in the longer term. Other imbalances, most notably the current account imbalances within EMU, need to be addressed to avoid a deflation spiral that would aggravate sustainability problems in highly indebted countries. The Greek crisis highlights the need to take steps to strengthen the economic governance of the euro area. A key component of these steps will be a stronger, growth-oriented surveillance.

If the fiscal position in one or more euro area members deteriorates, their financing will take place at increasing costs, if at all, and contagion could spread to the euro area as a whole. In some cases, debt might not be sustainable and would have to be restructured. The first step towards stronger economic governance therefore is to insure debt sustainability. This task lies foremost with countries that have to implement the right policies. Incentives to do so, however, may not be available and this, in turn, requires both an effective and credible surveillance mechanism and the necessary resources to support crisis resolution.

An unsustainable debt position can be the result of two quite different mechanisms. The first is a protracted lack of fiscal discipline in an otherwise weak economy, as in the Greek case. The second one is the (Spanish) case where a prolonged period of fiscal discipline was reversed as a consequence of the collapse of growth, itself the result of an unsustainable private sector growth mechanism. In both cases, the debt/GDP ratio has taken on a rising dynamics although for different reasons. So a more effective system of surveillance will have to monitor both the dynamics of debt and the sustainability of GDP growth. The Stability and Growth Pact (SGP), as we know it, partly takes the first aspect into consideration and neglects the second. So the SGP should be modified accordingly. One way to do this is to consider the composition of public spending and taxation when judging countries' fiscal positions. Some spending items (such as education and R&D) are more growth-oriented than others and some taxes (such as carbon tax or a consumption tax) are less harmful to growth. Both should be protected when a government embarks on fiscal consolidation.

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This note is a personal contribution and does not necessarily reflect an official OECD view.

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Countries with a weak fiscal position tend to run current account deficits, which need to be financed, and as this process becomes unsustainable market confidence deteriorates. Current account deficits however are also the result of deteriorating competitiveness, which is reflected in appreciating real exchange rates. In the euro area, relative competitive positions have been diverging in tandem with widening current account imbalances. Again there is scope for a stronger surveillance to insure that deficit countries take measures to improve their competitiveness by addressing the underlying causes of rising inflation and declining productivity, for example through appropriate wage policies and structural reforms. On the other hand, I see no rationale, nor any benefit for the euro area, in prescribing surplus countries to slow or even revert their productivity growth. On the contrary, surplus countries should make efforts to increase their productivity growth. This would address the issue of current account imbalances as follows. A current account surplus is the result, other things being equal, of excess savings over investment. Such excess savings partly reflect structural determinants, hence they should be addressed through structural measures. In some cases, such as in China, a very high savings rate signals the need to reform the welfare system and the financial system, so as to decrease savings in households and state-owned enterprises. In the euro area the obvious case is Germany, where, however, the main goal should be to increase investment. This could be obtained by liberalising (and thus increasing productivity in) the service sector, which remains largely protected from foreign competition and where more competition would spur innovation. In parallel, deficit countries should implement reforms that would increase savings such as increasing retirement age.

In sum, an important step towards better economic governance in the euro area would be the creation of a stronger surveillance mechanism that would focus on: fiscal sustainability, growth sustainability, competitiveness and structural determinants of current imbalances. Adjustment in such variables clearly requires time and a financing mechanism to smooth the process. But this is what a monetary union is about. To implement this mechanism, the European Commission should be given a mandate to extend and intensify surveillance activities. In addition a financial facility for programme lending should be established on a permanent basis (and not just on an ad hoc basis as in the case for Greece). The combination of these two factors would be the equivalent of a European Monetary Fund with a minimum of institutional change.

A necessary additional factor, however, is effective enforcement of surveillance recommendations to maximise crisis-prevention benefits. Would a stronger peer review mechanism suffice to complement the disciplining pressure of markets? Hopefully so, but enforcement mechanisms require carrots and sticks, especially when the economic situation risks veering off track. In a world where imbalances persist over time, debt levels will be higher almost everywhere, and market financing is a permanent factor and hence where credibility is essential, the stick is tough conditionality (based on strengthened surveillance) and the carrot is the availability of emergency financing.

Conversely, suggesting that euro area members facing a debt crisis should be invited to leave monetary union could imply much higher costs than benefits. A number of practical problems arise. For example, exiting the euro means reintroducing a national currency, a process that takes significant time and effort. How would such a process be managed while dealing with a crisis? Second, under what conditions should the exit be requested (imposed, negotiated)? It is not at all obvious that debt sustainability would improve after the massive devaluation of the new currency (with respect, say, to euro entry rates). Last but not least, what about contagion, and the loss of credibility for the euro area as a whole? One could go on with other questions, but I leave it to the proponents of the exit option to bring forward convincing arguments.