IMPROVING EUROPEAN DEMOCRATIC ACCOUNTABILITY: TOWARDS AN ECONOMIC AND FISCAL FEDERATION BY EXCEPTION

*Jean-Claude Trichet**

ABSTRACT

Since its foundation in 1999, the Euro area can boast major achievements as a monetary union: actual and anticipated price stability - attained despite several oil and commodity shocks and the impact of the worst crisis in the advanced economies since World War II – and aggregate figures for job creation, the balance of payments, public deficits and public debt that compare favourably with those of other major advanced economies such as the US or Japan. The origin of the current crisis must therefore be sought in the imbalances *within* the Euro area, and the consequent loss of creditworthiness of some countries, that have arisen mostly because of weaknesses in economic governance – such as the incomplete implementation of the Growth and Stability Pact, the lack of serious monitoring and surveillance of competitiveness indicators, the slow pace of structural reforms and the absence of crisis management tools. Contrary to common belief, Europeans have been decisive and bold in designing new tools to address these weaknesses. Furthermore, the European Institutions are currently envisaging a number of promising avenues for the medium term future. One particular idea worth considering is the "the activation of an economic and fiscal federation by exception"- the idea that when, in extreme cases, a country is unwilling or unable to adopt fiscal and economic measures required to avoid jeopardising the stability of the whole Euro area, action would be delegated and taken by the European Institutions. The activation of such a centralized decision making process would be made at the request either of the country concerned or of the Commission and the Council. In order to ensure full democratic accountability of the process, the ultimate decision would be taken by the European Parliament after due dialogue with the national Parliament of the country concerned.

---

*President, European Central Bank 2003-2011.This article is based on a speech delivered by the author at the EIB Institute on 6th March 2013

Improving European Democratic Accountability:

Towards an Economic and Fiscal Federation by Exception

*Jean-Claude Trichet**

Since mid-2007, the advanced economies have experienced extraordinarily demanding and difficult times. We have experienced a succession of shocks that were unseen in the industrialized countries since World War II. I remain convinced that the events that unfolded after the Lehmann Brothers incident were potentially even more critical than those which triggered the 1929 crisis. Had the central banks and the public authorities not embarked immediately on prompt and decisive action, I believe that we would have experienced not only a great recession but a very deep and rapidly unfolding great depression.

It is in this context of the gravest crisis of the advanced economies since World War II that I would like to concentrate on the European issues, and, more particularly, on the Euro area issues.

When people seek a justification for European integration, there is a tendency to look backwards. It is is always stressed in particular that European integration has banished the spectre of war from our continent. European integration has indeed delivered the longest period of peace and prosperity in European history. This perspective is entirely correct. But it is also incomplete. There are many more reasons for striving towards "ever closer union" in Europe today than there were in 1945. And these are entirely forward-looking. Sixty five years ago the distribution of global GDP was such that Europe had only one role model for its single market: the United States of America. Today, Europe is faced with a new global economy, reconfigured by globalization and by the emerging economies of Asia and Latin America.

It is a world where economies of scale and networks of innovation matter more than ever. By 2016 - that is, very soon - we can expect the Euro area GDP in terms of purchasing power parity to be below that of China whilst still being over and above the GDP of India. Together, these two countries would represent around twice the GDP of the euro area. Over a longer time horizon, the entire GDP of the G7 countries will be dwarfed by the rapid development of the systemic emerging economies. Europe has to cope with a new geo-political landscape very profoundly reshaped by these emerging economies.

And Europe is also faced with new global challenges, such as climate change and migration, where effective solutions are possible only at the European and international levels. In this new global constellation, European integration - both economic and political - is central to achieving prosperity and influence. The challenge is to set the correct path for European integration. Getting this right is essential to realize fully our continent's tremendous potential. Let me therefore lay out a vision for the Europe of tomorrow.

---

*President European Central Bank 2003-2011.This article is based on a speech delivered by the author at the EIB Institute on 6th March 2013

The creation of Europe's economic and monetary union is unique in the history of sovereign states. The Euro area constitutes a "society of states" of a completely new type. We have created progressively a concept which goes far beyond the Westphalian concept of sovereign states. Like individuals in a society, Euro area countries are both independent and interdependent. They can affect each other both positively and negatively. Good governance requires that both individual Member States and the institutions of the EU fulfill their responsiblities.

We have observed the functioning of the Euro area for 13 years. As all advanced economies, we have experienced the shock of the crisis over the last five years. It is time now to draw lessons from these first years.

The acronym EMU - Economic and Monetary Union - is made of three letters E, M and U, which means that we must have, and have indeed, two Unions: a monetary union M U, and an economic Union E U. I will next assess how both the Monetary and Economic Union have performed.

1. Achievements of the Monetary Union

I will not expand too much on the successes of Monetary Union. Let me only mention the following elements:

- <u>First</u>, the new currency, starting from scratch, has maintained price stability for an entire continent of seventeen countries and 333 million people. The average yearly inflation over the first fourteen years has been 2.07%.

- <u>Second</u>, savers and market participants trust the Euro to keep its domestic value as well in the future. Taking into account risk premia, the inflation expectations that one can draw from the financial markets are around 1.9% - 2% for the next ten years, in line with the definition of price stability of the ECB.

- <u>Third</u>, the track record of price stability and the anticipation of future price stability are not only fully in line with the mandate received by the European Central Bank and the Euro system from the European democracies, but are also better than what had been experienced in Europe before the Euro. For example, the Bundesbank, exemplary for its capacity to ensure price stability, could display an average yearly inflation of around 2.9% from 1955 to 1999.

- <u>Fourth</u>, this level of stability and of credibility has been attained despite several oil and commodity shocks and the impact of the worst crisis in the advanced economies since World War II.

- <u>Fifth</u>, this level of stability was not attained to the detriment of job creation. Between the setting up of the Euro on 1st January 1999 and the third quarter of 2012 the Euro area has created 14 million new jobs compared to around 11 million new jobs in the United States during the same period. This is not to say that there is not a large and acute unemployment issue in Europe: we have a lot of hard work to do, particularly eliminating with great determination structural obstacles to growth. And in the U.S. an episode of very active job creation already took place in the 1990s. Nevertheless, this little known comparison shows that, over a period of 14 years, there has been no obvious inferiority on this side of the Atlantic: all advanced economies have to dramatically improve their employment situation.

The achievements of the currency and the success of the Euro itself make it difficult to understand why Europe is today at the epicentre of the present crisis of the advanced economies. To understand that, one has to concentrate on the weaknesses of the "E.U.", the Economic Union itself.

2. Weaknesses of Economic Union

It is not the Euro area as a whole, on a consolidated basis, which is presenting major weaknesses: the current account of the Euro area is balanced, the public debt outstanding as a proportion of GDP is well below that of Japan and the yearly public finance deficit is well below the equivalent figures in the U.S., Japan and the UK. Nevertheless several factors, in particular the absence of effective surveillance inside the Euro area, have led to large differences between countries with regard to fiscal soundness, competitiveness and therefore creditworthiness. This explains why some countries are considered by investors and savers as vulnerable.

The weaknesses of the Euro area economic governance can be summed up under six headings:

- First, the Stability and Growth Pact designed to ensure sound fiscal policies in the Euro area has not been correctly implemented. Furthermore, in 2003 and 2004, the major countries, namely France, Italy and Germany, engaged in a dramatic move to weaken the Pact. The defence of the Commission, of the ECB and of the small and medium sized countries contributed to avoid the dismantling of the "letter" of the Pact. But the "spirit" of the Pact has been critically impaired

- Second, from the outset the governance of the Euro area did not include any serious monitoring and surveillance of competitiveness indicators, of nominal evolutions of prices and costs in any particular nation and of national external imbalances within the Euro area.

This second weakness was, in my view, the major problem for the governance of the single currency area, even more important than the loose implementation of the Stability and Growth Pact. Such an area is, by construction, a single "nominal currency" area. The main challenge of any such area is that it remains, over time, close to a single "real currency" area through a close monitoring of possible excessive disparities in competitiveness of Member States. On behalf of the governing council, in 2005, long before the crisis, I called for an appropriate surveillance of a number of national competitiveness indicators including the evolution of unit labour costs, associated with national current account imbalances.

- Third, the high correlation between the creditworthiness of the commercial banks of a particular country and the creditworthiness of the signature of the sovereign creates an additional vulnerability which is particularly damaging in the Euro area, and calls for an effective banking union at the level of the Euro Area as a whole.

- Fourth, no crisis management tools had been envisaged at the start of the Euro. This might appear as a serious initial mistake with the benefit of hindsight. But one has to recognize in this respect that "benign neglect" of possible acute crisis challenges was generalized at global level at the time of the setting up of the Euro. This was particularly the case in the advanced economies.

- Fifth, another weakness of the Euro area has been the unsatisfactory completion of the single market for goods and, more particularly, services. This weakness of the single market of all 27 European Union countries is particularly felt in the Euro area where it hampers the appropriate functioning of competition, an essential channel through which the economies concerned can achieve a commensurate and timely adjustment.

- And sixth, the slow and hesitant implementation of the structural reforms foreseen in the Lisbon agenda and in the 2020 programme for the European Union as a whole is equally hampering very significantly the smooth functioning of the Euro area.

Now let us look at what has been done until now to correct these weaknesses and what is presently envisaged in the medium term by the European Institutions.

Firstly, I would like to stress the fact that, contrary to common belief, Europeans have been decisive and bold in designing new tools, imagining new concepts and working out new rules. These new decisions have precisely been adopted to cope with the weaknesses I have just mentioned. Furthermore, the European Institutions are currently envisaging a number of promising avenues for the medium term future. In order to have an idea of this creativity of the European institutions, I would recommend reading in particular two documents: the "Blue print for a deep and genuine economic and monetary union. Launching a European debate" published by the Commission on 30th November 2012; and the document, published by Herman Van Rompuy and reporting to the European Council in the name of the four presidents, entitled "Towards a genuine Economic and Monetary Union".

The decisions already taken represent undoubtedly an important step in the right direction and address, with varying degrees of effort, all six weaknesses mentioned here. The "European semester" and the so-called "six packs" already decided and "two packs" are coping with the two first weaknesses: they reinforce very significantly the Stability and Growth Pact (SGP), and give the Commission more clout in case the governments would be inclined, as was the case in the past, to be too lenient vis-à-vis loose fiscal policies. The same set of secondary legislations introduces a new framework for surveillance: the "Macroeconomic Imbalance Procedure (MIP)" is designed to correct the second major weakness, namely the lack of surveillance of competitiveness developments and ensuing macroeconomic imbalances. The "Treaty on Stability, Coordination and Governance" (TSCG) reinforces significantly the effectiveness of the SGP by introducing its budget rules in national legislation. This part of the new Treaty signed March 2nd 2012 by 25 EU member states (all but the UK and the Czech Republic) is usually called the "Fiscal Compact". It also sets criteria for a reinforced surveillance of economic policies. A remarkable feature of the Treaty is that the Euro area Member States will support the Commissions' proposals or recommendations if a "Euro area Member State" is in breach of the deficit criterion, unless a qualified majority of Member States them opposes them. This reverse qualified majority voting (RQMV) is one of the major advances of the new Treaty.

Important decisions in principle were also made at the end of 2012 to deal with the third weakness, namely the absence of a banking union in the Euro area, On December 13th and 14th 2012, the Council supported the "Single Supervisory Mechanism" (SSM) which gives the ECB a key role and called for rapid implementation of a single rule book. The Council also calls for a Recovery and Resolution Directive and for a Deposit Guarantee Scheme Directive to be worked out during 2013. The very existence of the Single

Supervisory Mechanism will permit the implementation of a very important decision in principle taken previously by the Council, namely the possibility for the European Stability Mechanism to recapitalize banks directly, without necessarily going through the Treasury of the country concerned.

As regards, the fourth weakness, namely the absence of crisis management tools, the European Stability Mechanism (ESM) has been progressively set up. It is, in my opinion, too modest in size and its management is too complicated because of its intergovernmental nature. But it is nevertheless remarkable that the seventeen European governments of the Euro area could agree on a crisis tool that was not in line with the very strict interpretation given to the "no bail out" clause by some of them (that goes beyond the legal Treaty requirements).

–Several ways have also been imagined to improve the situation with regard to the fifth and sixth weaknesses, namely the non-completion of the single market and the insufficient implementation of structural reforms. For instance, Article 11 of the Treaty on Stability, Coordination and Governance calls for systematic ex ante coordination of major economic policy reforms. One of the most imaginative possible instruments to be used to further structural reforms is the "Convergence and Competitiveness Instrument" (CCI) which would encompass contractual arrangements negotiated between a particular country and EU Institutions and underpinned by financial support. This instrument should be activated in close connection with the Macroeconomic Imbalance Procedure (MIP) so as to foster the implementation of the corrective action plan. And there is an explicit recognition that the completion of the single market is of the essence in present circumstances.

To sum up, what has been decided already – and has to be implemented as actively, comprehensively and swiftly as possible - is significant and a testimony to the European reaction to the crisis. I have described above eight operational frameworks of diverse nature: the European semester, SGP, MIP, TSCG, ESM, RQMG, SSM, and CCI. Putting aside the Stability and Growth Pact, seven out of these eight frameworks are new and are the direct consequence of lessons learnt from the crisis.

That being said all this is not sufficient. More has to be done in the medium term as is recognized by the European Institutions. Most of what remains to be done would call for Treaty changes - as, by the way, has been the case for the "European Stability Mechanism" (ESM) and for the Treaty on Stability, Coordination and Governance (TSCG).

The ideas that are currently being suggested for the medium and long term by academics as well as by the European Institutions - what Herman Van Rompuy presents as "stage 3" or what the President of the Commission regroups under the heading "the medium term" and "the longer term" vision – could imply movement in three possible directions :

- Firstly, embarking on a financial route which would involve new Euro area sovereign instruments, whether Euro-bonds with various functions (including the financing of a possible redemption fund), or Euro-bills (with the aim of stabilizing short term volatile government debt markets);

- Secondly introducing a kind of embryo of a federal budget. That could be done in creating a “shock absorption” function at the central level, which could be the equivalent of an insurance mechanism against asymmetric shocks (either through a pure macroeconomic approach or an approach based on cyclically sensitive expenditure such as unemployment insurance). This concept should avoid net transfers in favour of any country over the economic cycle in order to ensure that it is a shock absorption rather than a transfer mechanism. Another approach would be to give the Euro area some specific fiscal responsibilities with dedicated budgetary and own resources;
- And, thirdly, reinforcing the democratic legitimacy and accountability of the European institutional framework. Several ideas are being floated in this direction, of which two deserve particular attention. The first is a new concept of very close cooperation between national and European Parliaments, explicitly mentioned in Article 13 of the Treaty: a “Conference of representatives of the relevant committees of the European Parliament and of the National Parliaments”. Secondly, new responsibilities could also be given to the European Parliament itself, particularly as regards the possible new “embryo” of a federal budget. This would imply forming a particular subdivision of the European Parliament, restricted to the MP’s that are members of the Euro area countries. The legal difficulties associated with such an avenue, should not be underestimated and would call for important Treaty changes.

All these avenues are interesting and are worth exploring. What is particularly important in my view is that, whatever new concept is envisaged, it should be designed with great care for detail, so as to allow the assessment of its technical, economic and political feasibility.

3. The activation of an economic and fiscal federation by exception of the Euro area.

Looking myself for a possible additional significant advance in the direction of an “economic and fiscal federation” I was wondering: which kind of concept/process could meet the following five requirements?

1. Being bold enough and sufficiently powerful symbolically to suggest a big step forward - I already mentioned previously that the Euro area needs a “quantum leap” towards a much more substantial economic governance, towards an economic and fiscal federation;
2. Being operational in giving, in exceptional cases, the various European Institutions the kind of responsibilities they would have in a full-fledged economic and fiscal federation and checking their capacity to meet effectively their possible new responsibilities and new powers;
3. Being fully democratic and therefore giving the last word as regards the decision to the direct representatives of the European people, namely the European Parliament;

4. Meeting the subsidiarity principle, i.e. being activated only in cases it would be absolutely necessary for the sake of the Euro area and for Europe as a whole;

5. And, last but not least, being effective in making sure that the kind of economic and financial destabilization experienced during the last years would be prevented in a convincing way.

I think that there is a new concept that could possibly meet these five requirements. It would be based on the two present surveillance frameworks mentioned earlier: the Stability and Growth Pact (SGP) and the Macroeconomic Imbalance Procedure (MIP). In the present secondary legislation, a country that would behave in an extraordinarily improper manner and consequently put at risk the stability of the Euro area as a whole would face sanctions in the form of fines representing a certain percentage of the country's GDP. Experience has demonstrated that these possible fines are not effective. A country behaving very improperly does not seem to be deterred by fines which would only add to the financial difficulties of its own making! That is the reason why I would suggest to replace the "fines" by an entirely new decision making process.

This new process would be activated only when a particular economy would appear to be unwilling or incapable to take the fiscal and economic decisions required to avoid the destabilization of that country and consequently of the Euro area as a whole. It could be activated either by the country concerned, challenging the pertinence of the recommendations received from the Commission and the Council, or by the Commission and the Council themselves to prevent the spill over of bad national management on the whole of the Euro area. The required decisions would then be taken at the centre - by the European institutions and not by the country itself. The Commission - acting in this case as a federal government - would propose the appropriate decisions (i.e. a 3% increase of the VAT, the freeze of categories of fiscal expenditure, etc.). The Council - acting as the equivalent of an upper Chamber - would examine the proposed decision and make its own judgment. And the European Parliament - acting as the lower Chamber with its MP's elected directly by the citizens of Europe - would have the last word and decide democratically on the proposed measures.

I would call this decision making process - limited to absolutely exceptional cases- "the activation of an economic and fiscal federation by exception".

4. The democratic anchoring an economic and fiscal federation by exception of the Euro area.

This decision making process would meet the five criteria previously mentioned: it would be bold, operational, democratic and effective and meet the subsidiarity principle. The fact that the country concerned could challenge the wisdom of the Commission and the Council and appeal to the European Parliament reinforces subsidiarity. But the main feature from the standpoint of our democracies is precisely its democratic anchoring.

The fact that sharing a single currency also means accepting limitations to fiscal sovereignty is not new. Limiting fiscal sovereignty in exceptional cases was already included in the Maastricht Treaty: the Stability and Growth Pact foresees the possibility of imposing sanctions - in the form of fines, including very significant ones - if a

government, or a Parliament, or both are not meeting the Stability and Growth Pact provisions and not respecting the Commission and Council recommendations. The new concept I suggest draws the consequences from the fact that the fines have proved ineffective.

The most important element of the new proposed concept would be its strong democratic anchoring. One has to be sure that the activation of the "federation by exception" is subject to a fully democratic decision making process, and that democratic accountability is undisputable. That is the reason why the European Parliament should be called to play a fundamental role in the decision, on top of the role played by the Commission and the Council. More precisely, for the decisions to be effective, the European Parliament would have to approve by a majority vote the measures proposed by the Commission and approved by the Council. As long as the Euro area does not coincide with the European Union as a whole, only the members of Parliament elected in the Member Countries of the Euro area would vote.

It would be necessary to organize in the best possible way the dialogue between the European Parliament and the national Parliament of the country concerned. In these exceptional circumstances, where the stability and the prosperity of the Euro area as a whole would be at stake, the national Parliament should have the possibility of explaining why it is unable or unwilling to implement the recommendations proposed. Symmetrically, the European Parliament could explain why the stability and the prosperity of the Euro area as a whole are at stake. That being said, in the activation of this "federation by exception", after a deep and appropriate dialogue between the two Institutions, the last decision would belong to the European Parliament.

The legitimacy of the participation of all Members of the European Parliament elected in Euro area countries seems to me very strong. It would indeed be their own electorates' stability and prosperity which would be put at risk in such exceptional circumstances where one particular economy behaves dangerously.

This decision making process would be fully in line with the concept of subsidiarity which has been applied since the introduction of the Stability and Growth Pact. As long as the policy which is pursued is in line with the framework, or is being redressed according to the recommendations of the Commission and the Council, there are naturally no sanctions. But when the policy pursued is threatening to contradict so gravely the rules and to put in jeopardy the stability of the whole Euro area the procedure leading to possible sanctions is activated. The country can appeal to the European Parliament for an ultimate decision if it judges that the recommendations of the Commission and the Council are inappropriate and/or unapplicable. In any case, whether at the request of the country or of the Commission and Council, the final decision is taken by the European Parliament.

The Euro area is presently learning the hard way that the level of interconnection between economies inside a single currency area is such that even an economy of a modest size can impact significantly the Euro area as a whole. This is precisely the limit of the subsidiarity principle.

In a short to medium term perspective, the concept of the activation of an economic and fiscal federation by exception might appear very bold indeed. In a much longer term perspective, it might look as a quite shy and timid idea when a full-fledged political federation – the United States of Europe - would appear to be the legitimate objective.

But taking in to account the very nature of Europe - the fact that our nations have very ancient historical, social and political roots - it is likely that European countries will remain in the very long run profoundly attached to the subsidiarity principle. So even in a very long term perspective it is possible that in economic policy matters it will appear appropriate for the European future federation not to go necessarily much further than this "activation by exception" of economic and fiscal federal governance. The scope of interventions and the measures taken by the federal institutions would thus rely, even in the much longer term, on the principle of "as little as possible in normal times, but as much as necessary in exceptional times".

5. Concluding remarks

These are new ideas which might be worth examining. I have had previously occasions to suggest the setting up of a Ministry of Finance of the Euro area. This Ministry would have the responsibility of activating the economic and fiscal federation when and where necessary. It would be responsible for the handling of the crisis management tools like the ESM. It would also be responsible for the handling of the banking union, within the limits of the executive branch responsibility. And it would represent the Euro area in international institutions and informal groupings, such as G7, G8, G20, etc. The Minister in charge would be member of the future executive branch of the European Union, together with the other ministers responsible for other possible federal departments.

In this perspective, the Commission would appear naturally to be the anticipation of the future European democratic government as has been suggested by Minister Wolfgang Schäuble, in his recent Karl der Grosse prize speech, with his proposal for an election of the President of the Commission. As I said earlier, the Council appears to be the anticipation of the future European upper chamber. And we already have the lower chamber elected by all European fellow citizens.

I am aware of the boldness of some of the ideas presented here. But I really think that it is necessary for Europeans - as well as for the citizens of all advanced economies - to draw all the lessons from the past and from present events. It is time for us to clarify the nature of the "quantum leap" that is necessary for our future governance if we want to ensure that our single "nominal currency" area remains a single "real currency" area over time. One thing is sure: this governance would have to be fully effective when demanded by circumstances. It would have to be fully democratic with a deep and decisive involvement of the European Parliament. And it would have to meet the subsidiarity requirement which is in the very nature of the European construction.

Jean Monnet once said: "People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them". I strongly believe it is time to move ahead.