



Fixing the Flaws in EMU

The euro area's long-term survival requires a fundamental transformation of policymaking

Florence Jaumotte

DURING its first decade, the euro delivered on its promises. Economic and Monetary Union (EMU) led to strong economic and financial integration among its members and prompted a catching-up process for the poorer countries on Europe's geographic periphery, aided by capital pouring in from the richer countries in northern Europe. EMU's apparent success led many to forget some initial misgivings. Was it really an optimal currency union? Would countries have enough flexibility to handle shocks without recourse to the exchange rate or an independent monetary policy? Did current account imbalances really not matter in a currency union?

These questions are back with a vengeance. Imbalances clearly matter. Many countries are buckling under large public and private debt and collapsing housing markets. Private capital is fleeing the periphery faster than it arrived. Pressure has spilled over into the rest of the euro area, leaving policymakers scram-

bling to come to grips with a broader, near-existential crisis.

This raises two questions: How did things go so wrong? What can be done to prevent a recurrence of these problems?

The burden of success

EMU worked almost too well. During the run-up to currency union, countries undertook reforms to achieve the fiscal and inflation standards required to join the club. These policy improvements and the elimination of exchange rate risk led to a decline in the cost of borrowing for the countries adopting the euro, helping achieve fiscal sustainability for all. The buoyant growth prospects in the periphery countries attracted abundant capital during a period of macroeconomic stability and high growth in a number of euro area countries.

However, the low interest-rate environment led to excessive borrowing and inflated bubbles in some periphery countries, which started living beyond their means by accu-

EU flags in front of the EU Commission in Brussels, Belgium.



mulating debt owed mainly to other euro area countries. This would have been fine if they had used the borrowed resources to build production capacity, including in the export sector. But much of the money went into real estate investment, other nontradable sectors, and household and government consumption. The resulting boost in domestic demand triggered higher wages and prices, which decreased competitiveness relative to the rest of the world. The integration of China and other emerging economies into global production chains also cost many periphery countries market share abroad.

Widening imbalances

National policies and institutions, financial markets, and a lack of proper euro area policy coordination all contributed to widening imbalances.

First, *policymakers adopted a very short-term perspective*. Some governments went on a spending spree (Greece, for instance, and to a lesser extent Portugal), aggravating the boost in domestic demand from the flow of credit. In other cases, governments failed to tame booming private demand—for example, by building up sufficient fiscal surpluses and saving for a rainy day. As often happens, temporary increases in output caused by an oversized real estate sector and booming tax revenues were mistaken for permanent improvements in the budget position and were used to fund tax cuts and expenditure increases that proved unsustainable when the global economic crisis hit.

Second, *the structure of product and labor markets often contributed to excessive wage and price increases*. Especially in the periphery countries, limited competition in the service sector enabled firms to charge high markups and grant large wage increases because these costs could be passed on to customers via higher prices. And wage bargaining between social partners at the industry or regional level often failed to adequately account for the impact of wage demands on the overall level of employment and competitiveness. Widespread indexation of wages to inflation also contributed to the persistence of high inflation in some countries.

Third, *financial markets failed to impose market discipline*. Despite the increasingly unsustainable growth pattern and mounting foreign debt of periphery countries, financial markets as well as regulators and supervisors showed little concern until mid-2007. This may be attributable in part to a global decline in risk aversion during this period—large-scale financial crises were seen as only a remote possibility—leading to more risky investment behavior. Also, with the advent of EMU, there was a belief that current account imbalances would not matter and that the Stability and Growth Pact (SGP)—the European Union’s mechanism to keep budget deficits and public debt in check—would be enough to prevent crises.

Fourth, the emergence of imbalances resulted from a *failure to properly coordinate policy at the euro area level*. The SGP was inconsistently applied, and flouted even by some of the largest countries. The euro area’s inability to monitor and enforce the SGP contributed to the Greek sovereign debt crisis.

The lack of progress toward fiscal federalism may also be partly to blame for the emergence of imbalances—the cur-

rency union was not well equipped to smooth out regional economic disturbances. The European Financial Stability Facility (EFSF) and the recent proposal for a euro area fiscal authority go some way toward risk sharing and strengthening governance but came too late to prevent the current crisis.

Finally, regulatory and supervisory policies for the financial sector were insufficiently coordinated, making it difficult to spot excessive exposure or borrowing. Stricter euro area-wide banking regulation could have helped prevent bubbles in periphery countries.

Fixing the currency union

The debate over what it takes to achieve a well-functioning currency union is not new. The optimum currency area theory emphasizes price and wage flexibility, labor mobility, and fiscal transfers as adjustment levers in the absence of a national exchange rate and interest rate. Price and wage flexibility enables a country to adjust to adverse economic shocks and restore competitiveness by reducing wages and prices relative to other countries. Labor mobility allows people to move to faster growing regions, and well-designed fiscal transfers from stronger countries or regions to weaker ones can help smooth adjustment.

But while the initial debate focused on how individual countries would adjust to negative shocks, the years leading up to the global economic crisis highlighted another challenge—how to prevent domestic demand bubbles in a currency union. Such bubbles have undesirable lasting consequences: the accompanying wage and price increases are hard to reverse in a currency union, and debt-financed bubbles expose a country to refinancing risk once confidence wanes.

This raises yet another challenge specific to currency unions—how to fend off speculative attacks on individual countries without an exchange rate buffer or a national lender of last resort.

The four must-haves

In light of these old and new challenges, what are the prerequisites for a well-functioning currency union in Europe?

1. **Stronger fiscal discipline.** Reforms must enhance fiscal discipline at the national level and promote more active countercyclical use of fiscal policy. The economic governance reform package that was approved by the European Union in fall 2011 (the “six-pack”) goes in this direction: it limits expenditure growth, enables the activation of excessive deficit procedures for countries with debt above the 60 percent limit set out in the Maastricht Treaty, and strengthens enforcement through quicker and semiautomatic sanctions. However, the new measures fail to significantly alter the incentives for responsible fiscal policies. To ensure bullet-proof discipline, the following measures should be considered:

- Embedding structural balanced budget rules in constitutional law at the country level, as was done recently in Germany.
- Further strengthening fiscal surveillance through the SGP, including by initiating excessive deficit procedures



through reverse qualified majority (this decision-making rule implies that the European Commission's assessment prevails unless the Council of Ministers decides otherwise by qualified majority). An even stronger measure would be to subject national budgets in violation of SGP limits to a veto from a euro area fiscal authority, established jointly by the Council and the Commission.

- Introducing an automatic EU-level fiscal transfer system to offset temporary country-specific shocks. Without control over interest rates, national spending and tax policies are the main tools to regulate domestic activity and cool excessive demand. An EU-wide system would help countries save more in good times because part of the temporary surge in government revenues would be transferred to a central budget instead of financing hard-to-reverse growth in primary expenditure. Countries would also have more room for fiscal expansion in downturns without further increasing their debt because they would benefit from transfers.

2. *More effective crisis-fighting tools.* The euro area needs a common defense system to protect individual countries against self-fulfilling speculative attacks, without jeopardizing incentives for fiscal discipline.

Under the newly created EFSF (which will later become the European Stability Mechanism), a member can receive assistance through guarantees or loans from other countries. But limited resources have been committed so far, which raises doubts about the effectiveness of this new contingency fund.

In the short run, to the extent that the euro area is facing a confidence crisis, the European Central Bank (ECB) could play a larger role to keep monetary conditions uniform throughout the currency union. But there are drawbacks. ECB intervention may weaken the perceived need for adjustment and jeopardize its independence and credibility. In the longer run, common euro area bonds (with joint liability and adequate guarantees that national governments will pursue sound fiscal policies) are an attractive option and a credible form of fiscal integration.

3. *Improved competitiveness.* Prices and wages must be set with a view to preserving or regaining competitiveness. So far, not enough has been done to fundamentally reform euro area labor and product markets with this objective in mind.

A new "excessive imbalances procedure" adopted in fall 2011 aims to monitor competitiveness and indebtedness and ensure that countries respond appropriately and quickly to address emerging imbalances, but the conditions for its effectiveness are lacking. The commitments made by national leaders under the Euro Plus Pact to strengthen competitiveness and employment do not live up to expectations. Crisis management tools should also be used more actively to make financial support conditional on structural reforms, as is increasingly the case for the countries that are receiving financial support through joint EU-IMF adjustment programs.

Some labor and product market institutions are more conducive to adjustment than others. When labor market institu-

tions see maintaining competitiveness—and thus jobs—as a shared responsibility, higher levels of employment and growth generally follow.

Either full decentralization to the firm level or national coordination of wage setting seems to yield superior outcomes, particularly when wages are not indexed to inflation. Equal employment protection for all workers and removal of barriers to hiring and firing are also beneficial, along with active labor market policies and adequate unemployment compensation to help workers retrain and move into new jobs. Labor market reform should be complemented with stronger competition, especially in nontradable sectors shielded from foreign competition.

4. *Euro area-wide financial safeguards.* Cross-border capital flows in the euro area increased dramatically in the wake of EMU and with the elimination of exchange rate risk, though the current crisis has led to some retrenchment. Institutions must adjust to the reality of a highly interconnected financial system and to the need to break the adverse feedback loop between weak public finances and weak banks. Strong supervision at the euro area level must spot excessive exposure or expansion of banking systems. Banks can no longer be treated as purely national institutions: a euro area-wide approach to crisis management and resolution is needed, with a common fund available to support troubled financial institutions.

Progress on reform is probably greatest in the financial area, thanks to the new European Supervisory Authorities responsible for coordinating microprudential supervision and the establishment of the European Systemic Risk Board, charged with macroprudential oversight at the European level. However, the agenda and its implementation must be more ambitious, with faster progress toward a single rule book, a European resolution authority, and unified deposit-guarantee and resolution programs.

Finally, obstacles to equity flows should be removed. Equity flows buffer the impact of a crisis because private investors share in losses, easing some of the burden of adjustment on debtors. Unified financial regulations and less national economic protectionism will facilitate cross-border equity flows.

In conclusion, fixing the current problems and preventing new imbalances call for a fundamental transformation of policymaking at both the euro area and national levels beyond recently adopted measures to fully internalize the constraints of monetary union. Only then will its 17 member countries be able to safely reap the full benefits of Europe's common currency. ■

Florence Jaumotte is a Senior Economist in the IMF's European Department.

This article is based on a forthcoming IMF Staff Discussion Note, "Imbalances in the Euro Area: How to Prevent Their Recurrence," by Florence Jaumotte, Fabian Bornhorst, Anna Ivanova, Yuko Kinoshita, Hanan Morsy, Esther Perez, Thierry Tresselt, Irina Tytell, Jérôme Vacher, Sebastian Weber, and Johannes Wiegand.