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Three conditions for a fruitful discussion on the governance of the euro area

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On his first visit to Brussels, only a few days after his inauguration, French president Nicolas Sarkozy announced that France would soon take the initiative to improve the economic governance of the euro area. He was not specific – saying that the discussion should only be opened after the constitutional debate has been settled. But he hinted at the need for a pro-growth policy, at better dialogue between the ministers of the euro area (the Eurogroup) and the European Central Bank (ECB), and at a more assertive exchange rate policy.

When they are unveiled, his proposals will certainly be received with caution by European partners, including Germany. There are three reasons for that. First, during the French presidential campaign Nicolas Sarkozy (and Ségolène Royal) gave the impression of having second thoughts about some of the basic tenets of the European monetary union, and more than once embarked on ECB-bashing. Second, early official statements on French fiscal policy are at odds with a recent commitment by the thirteen finance ministers of the euro area to reach budget balance by 2010. Third, French proposals to strengthen the euro area are often suspected to result from frustration with a too large and too diverse EU-27. A guarded attitude can thus be expected from the non-euro area member states, who will challenge any proposal that could pave the way to building a smaller Europe within the large one. This implies that if Nicolas Sarkozy wishes to hold a fruitful discussion on the issue, he should first dispel ambiguities.

He has already said that he does not intend to challenge the independence of the ECB. More explicit statements will, however, be needed in order to banish the impression created by the campaign. A strengthening of the Eurogroup does not need to imply a weakening of the ECB or a threat to its independence, but a misguided attempt to strengthen it could. Clarification on this front is therefore a key prerequisite to discussions.

A second condition for being listened to is to credibly spell out the course of future French fiscal policy. Over the last ten years, France has repeatedly called for fiscal coordination but seldom practiced it. It also lacks the domestic rules and institutions that would ensure that announcements are followed by deeds. As a consequence, France's commitments to its European partners lack credibility. Recent declarations on the need for a "tax shock" and a "pause" in the reduction of the deficits won't make things better. Home-grown reforms are needed to stake out and enforce a genuine commitment to fiscal sustainability.

The third condition is to make clear that the door of the euro area remains open to all EU-27 member countries. Last year the rejection on disputable legalistic grounds of Lithuania's application for euro membership created mistrust between the old and the new EU member states. A good way to rebuild it would be to indicate a degree of flexibility on the implementation of the criteria for membership. To request from candidates that their inflation rate remains within bounds determined by countries which do not participate in the euro area (because the initial criterion was based on the three best performers within the EU) is economic nonsense. At the same time, there is a case for a tough stance on fiscal performance. France would be well advised to spell out its thinking in this field. Again, a signal that the desired strengthening of the euro area can be combined with an inclusive vision of its future would help build confidence.

Assuming now that those three conditions are met, is there room for discussion on the economic governance of the euro area? Some will deny any useful purpose to such talks, saying that EMU is fully equipped with procedures and institutions. This would amount to denying the fact that, in spite of all the preparations, monetary union remains a learning process and that participating states must draw lessons from experience, assess challenges and introduce reforms when appropriate. The reform of the Stability and Growth Pact of 2005 is a case in point. When, after France and Germany had made an alliance to avoid going down the path to sanctions, discussions were initiated on the reform of the Pact, many observers claimed that reform would only result in watering down fiscal discipline. When the reform was announced, many also said that the Pact was dead. In the event, the new Pact served fiscal discipline better than expected through shifting the focus from ex-post punishment to ex-ante guidance.

Similar issues arise today in other fields. The reform record of euro-area countries is disappointing, though they should logically be at the forefront of those reforms which enhance integration and improve the responsiveness of economies to shocks. Against the background of domestic rigidities, divergent labour cost and inflation performance is a cause for concern: countries like Portugal or Italy, whose competitiveness has deteriorated, have to undergo long and painful adjustments. Spain is confronted with the bursting of the real estate bubble. Yet the thinking behind the early EMU set-up was that monetary union would encourage reforms and that the risk of divergence would be taken care of by fiscal discipline. Experience shows that the pace of reform is slow and that fiscal discipline is not sufficient to prevent divergence. Nor can the issues be left entirely to the responsibility of each country, as a member’s lack of reform or excessive real appreciation would be likely to complicate the conduct of the single monetary policy and to have consequences for liberalisation within the single market. Hence, there is room for serious discussion about the promotion of reforms, the prevention of divergence, and the instruments the Eurogroup can rely on for that purpose.

Exchange rate policy is another topic. The Maastricht treaty was drafted at the time of the Plaza-Louvre exchange-rate management agreements between the dollar, the yen and the German mark (nobody at that time spoke of the renminbi) and resulted in an awkward compromise between a tradition that regarded exchange rate policy as an integral part of monetary policy and another that regarded it as an independent instrument. In practice, the former has prevailed so far, a natural and welcome evolution in a floating exchange-rate context. However today’s world does not consist of independent floaters only. An important question for Europe is, for example, what part China will play in the expected international rebalancing. This is not a challenge the ECB alone can tackle, because it involves government policies and belongs to the realm of diplomacy. This raises issues of external representation in international fora and the question of who is the voice of Europe, which also are legitimate matters for discussion.

Eight years on, the euro area is still in its infancy and it has so far benefited from an exceptionally favourable external environment. Important challenges lie ahead as history tells us that testing times for fixed exchange-rate regimes only come after some years. Discussions on its future and reforms in its governance should therefore be welcome, provided they start from a sound base. It belongs to the new French government to create the conditions for fruitful exchanges with partners.