TPS AND EUROPEAN INTEGRATION

By Niels Thygesen

Over nearly four decades I had the privilege in three periods to work closely with Tommaso Padoa-Schioppa – TPS for short – and, more permanently, to enjoy his friendship and hospitality.

The first period was 1971-72. Banca d'Italia showed the OECD the favour of nominating Antonio Fazio and TPS as members of a Monetary Experts Group (which still meets annually) that I chaired at the OECD to study the transmission mechanism of monetary policy in the largest industrial countries. They added greatly to the study and to the Italian part of it, and I remember with fondness the crash course on the Italian economy I received at Banca d'Italia in the summer of 1972. It helped that we were all three students of Franco Modigliani, but TPS was a particularly judicious guide to the intricacies of Italian monetary policy at the time with its many, now forgotten, instruments.

The second period was 1979-83. Almost on the starting date for the European Monetary System (EMS) in March 1979 TPS became Director-General of what is now DGECFIN at the European Commission, a nomination applauded not least by his academic friends. But what looked like the opening of a very promising period became one of some frustration for TPS. The plans of its founders to develop the EMS into a European Monetary Fund were quietly shelved, there were frequent realignments and little effort, at least until 1982-83, to seize these occasions for policy adjustments rather than accommodation of past inflation; and some smaller, more technical, improvements in the

functioning of the EMS proved difficult to agree on and generated some unjustified suspicions among German officials as to the motives of TPS.

This did not, however, lead him into passivity; he explored the appropriate future balance between global and regional financing of external deficits, memorably at a conference debate in Geneva with Jacques Polak of the IMF, and he organized through the Centre of European Policy Studies the CEPS Macroeconomic Policy Group - with his friend the late Rudi Dornbusch as Chair and with young European macroeconomists based in the US (Olivier Blanchard and Willem Buiter) together with more senior European-based colleagues (initially Giorgio Basevi and Richard Layard, later Herbert Giersch, Jacques Dreze and Mario Monti) as its early members - to offer advice to often reluctant European policy-makers in the Commission or in national governments. One key concept from the Group's contributions was "the two-handed approach" to economic policy : budget consolidation with a growth-friendly investment policy, a theme that TPS saw as more permanently relevant. He finally established a relationship as trusted interlocutor of Jacques Delors, who had become Finance Minister in France in 1981.

The third period was 1987-89. Two years after Delors had become President of the Commission he called on TPS to chair a working group (with Mervyn King and Lucas Papademos among its other members) which looked at the challenges to the European policy framework in its 1987-report "Efficiency, Stability and Equity", arguing that the stability function was beginning to lag behind the two other policy challenges, particularly as market integration deepened and capital movements were liberalized. With this view gaining ground at the political level in early 1988, Delors wanted TPS to serve as Secretary of the Committee on Economic and Monetary Union which Delors was asked to chair at the Hanover European Council.

The contribution of TPS to the Delors Report was crucial. Although he and could not speak in the meeting sessions, he had his say in preparing initial thoughtful questions to address and, decisively, in preparing – with his colleague Gunther Baer – well-balanced early drafts of the chapters in the Report which greatly facilitated agreement in the Committee. But he had an additional role in sustaining the Chair of the Committee after difficult meetings when the prospects of agreement seemed tenuous. TPS could usually see a way forward and he was notably more confident than Delors that the objections raised by one or more of the national central bank governors could be overcome at the next meeting – and how. As an insider among the central bankers he was obviously respectful of their hesitations, but not intimidated by them. In the end the members signed the Report unanimously.

That central bankers could agree on the outline was not as surprising as the subsequent consensus which developed at the political level. TPS was there, first to see the Report through the scrutiny of the Finance Ministry officials, then – as a key Italian negotiator working closely with then Governor Carlo Ciampi - in preparing the Intergovernmental Conference, convened in 1990 in Rome, and in persuading the Italian authorities towards the end of the Maastricht negotiations to push for an element of automaticity in starting the final stage of EMU in 1999 rather than looking every two years to see who was ready to join and whether they constituted a majority of Member States. Without that provision EMU might never have started. Finally, TPS was active in facilitating the return of the lira to the EMS in late 1996, just in time for Italy to qualify among the first participants in EMU. In June 1998 he began his seven years of service as a Member of the ECB Executive Board.

TPS was not only an inspiration for those policy-makers who saw the potential of EMU; he became a key figure in implementing the vision. In

this double role the unique combination of passion and patience which marked his personality came into full play.

In the rest of my comments I want to focus on the issue of governance in the Euro area which remained a major concern for TPS, as evident most clearly in his 2004-book “The Euro and Its Central Bank”; he clearly regarded the framework as work in progress.

The model of governance outlined in the Delors Report and basically accepted at Maastricht is today widely seen as lopsided. Centralising monetary policy, while leaving other macroeconomic and structural policies largely in national hands, though with budgetary policies subject to constraints on strongly deviant behavior, was 20 years ago the most that could find political support. But it also seemed economically defensible on two assumptions generally accepted at the time : (1) that the budgetary rules would be respected by participating governments and monitored by the their partners and the Commission, and (2) that the deeper integration of the markets for goods, services and capital then underway would keep national price and cost trends on broadly parallel tracks. We now know that these two optimistic, but not a priori unreasonable, assumptions proved unrealistic – and not only because the group of participants in EMU turned out to be much larger than expected.

In addition, there was a omission in the Maastricht framework, viz. that one could maintain a largely national approach to financial regulation and supervision in a unified currency area. Few officials or academic economists had the imagination to envisage the degree of financial interdependence that would develop with the introduction of the euro and how it would intensify at a time of crisis. The issue did not receive much attention in the Delors Committee, despite some prodding by TPS and a couple of members, may be because the central bank governors

were not keen to be given any responsibility for financial stability and hence to take on any such role jointly at the EU level. Only the Bank of England had supervisory responsibilities at the time, and most countries were building up national Financial Supervisory Authorities. Central bankers felt that responsibility for financial stability would inevitably lead to onerous political oversight and hence constitute a threat to autonomy in monetary policy. They have struggled to contain such dangers in the recent set-up of a European Systemic Risk Board which focuses on macroprudential issues, leaving the supervision of individual financial institutions to new European institutions.

The design of the coming European System of Central Banks – the only new and operational policy institution – was marked by a "purist" vision. TPS has in his 2004-book a fine analysis of the long swings in the focus of central banking : towards the end of the two turbulent decades of the 70s and 80s with on average high inflation the focus was firmly on creating the most reassuring framework for a joint monetary policy with medium-term price stability as its primary objective, and pursued by a central bank with a high degree of autonomy from political authorities and as few distractions from government finances, instabilities in the financial sector and in foreign exchange markets as possible. The prohibition of monetary financing of public sector deficits (and the no-bail-out rule), the absence of responsibility for financial stability and the deliberate impediments to any active exchange-rate policy interventions can all be seen as desirable safeguards of the central bank's main and highly autonomous role in monetary policy – and on these safeguards there was agreement between central bankers and the political authorities.

TPS was from the start uneasy with the design and he foresaw the need to eventually develop it further. In his 2004-book he warns against confusing central bank independence with loneliness; if the central bank

is effectively alone on the European policy stage, it may end up performing tasks which in a properly functioning system of governance falls to the political authorities. That could pose greater dangers to policy autonomy than those obviated by the safeguards in the purist design of Maastricht. This central message has become clear over the past two years of severe crisis in the Euro area ; the laxity with which national governments have treated the constraints imposed on their budgetary and other policies by EMU is the main cause of the crisis, but the "congenital" weakness of the original purist design has also become visible and in need of repair. TPS only lived to see the first of these two years of crisis, but he left some pointers as to what he saw as desirable improvements in the framework.

Without any doubt, TPS would have regarded the developments in governance in 2010-11 as useful, indeed necessary, but also as inadequate. To begin to take the budgetary rules and their monitoring seriously is indispensable, even if one may question whether the more legalistic provisions for the Euro area participants now under debate in the European Council are strictly necessary on top of what had just been enacted through the so-called "six-pack". In addition to that major updating of the rules, the brutal awakening to new forms of market discipline, and the experience of the countries that have had to borrow from the European institutions and the IMF and to negotiate harsh adjustments, will remain fresh in the minds of policy makers for a long time. To be "bailed out", officially or privately, is not an attractive option; it has become a powerful deterrent to misbehavior.

However, regardless of whether one regards the possible Treaty changes that emerged from the December 2011 European Council as essential or not, the proposals fall short of major steps towards policy coordination in any real sense. We were too generous at the time of the Delors Report

and the Maastricht Treaty in using the latter label for the framework under construction. Guidelines for budgetary behavior are designed to constrain individual country behavior; they can at best promise some indirect coordination. The recent proposals to reinforce them extend the asymmetry in policy-making in the Euro area where we have a central bank that addresses only policy issues common to the whole area, and a Eurogroup which speaks almost exclusively about individual countries without any aggregate view. Jaime Caruana mentioned in his intervention that TPS did not regard a multi-country strategy embodying only the prescription that each participant should "put his own house in order" – even when all participants do so systematically at the same time - as sufficient; the approach should be supplemented by a view of the aggregate, or joint, effort required.

Is there a way of meeting that challenge without simply slowing down the degree of joint austerity currently on the agenda ? TPS would hardly have been sympathetic to the calls, primarily from economists in the US or the UK, for expansionary budgetary policies in Germany and other countries in external surplus; after all the German public debt is presently close to the Euro area average of about 85% of GDP, leaving little room for looser policies. He would also have acknowledged that EMU was constructed to facilitate the spreading of the best national policies, rather than to further convergence to an average performance. But even the best-performing economies can do better by pursuing structural reforms and making the joint project of the Single Market advance, not least through better implementation of the Services Directive. Mario Monti's Report on the subject, delivered almost two years ago to the Commission, offers a number of implementable proposals. Allowing the EU long-term budget to grow modestly beyond its 1% of EU GDP, while recognizing that even in a pre-federal state it can be more efficient to spend at the EU rather than

at the national level, could be a further counterpart to the sole emphasis on joint austerity in the prevention of future crises. In informal conversations at the time of the Delors Committee I recall that our Chair thought that an EU budget in the order of 3%, rather than 1%, of EU GDP would be a natural and likely complement to the joint monetary policy in EMU; TPS shared that evaluation at the time. While still very much at a pre-federal level, such a budget would have permitted the beginnings of the type of stabilization functions which governments in large federations undertake at an early stage.

TPS would also in my view have been likely to ask whether all proposals for Eurobonds/Stability Bonds would have to be deferred until well after the tighter budgetary rules have demonstrated that they work. Various non-governmental sources – Bruegel, the German Council of Economic Experts and the European League for Economic Cooperation – have made proposals that in various ways limit the open-ended joint issues of sovereign bonds that have understandably been rejected by the most creditworthy governments as leading to moral hazard and as requiring major Treaty changes. They would all be complex to develop, so debate on them, including systematic comparisons, should not be long delayed; the Commission has put one of them (from Bruegel) on the agenda in its 23 November paper.

TPS saw, right from his EMS days in Brussels, the monetary unification of Europe as a process to be driven not only by political decisions, but also by financial markets. He would have been critical of the schizophrenic attitude of many national policy-makers in Europe towards markets. As long as financial markets supported interest-rate convergence – as they did until 2009 with surprising enthusiasm – that was taken as a great compliment; when markets became increasingly skeptical, and no doubt overreacted to divergences, they were vilified in the political debate. One

major challenge for future economic governance in the Euro area is to come to terms with monitoring by both markets and governments, marked by less violent and simultaneous swings in both.

The challenge is extremely difficult, as we have seen well illustrated throughout the crisis. Markets are impatient and look for decisive political moves rather than for a long drawn-out process of gradual progress. And markets look not only for more readily enforceable mechanisms of budgetary discipline, though that is an essential first step. The present crisis is to a large extent, but not exclusively, a budgetary crisis in individual countries. It is also one of severe imbalances between participants, as well recognized in the new procedures for monitoring external imbalances and competitiveness. The evolution of governance will have to address this dimension more explicitly and seek remedies for imbalances to ensure smooth relations with financial markets and, ultimately, with the European electorate. The advice of TPS will be sorely missed in this endeavour.