Europe's economic government

Or how to use the Treaty for more effective economic coordination in the euro area?

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This paper deals with the need for macroeconomic policy coordination in the aftermath of the financial crisis and the reasons for coordination failure in an increasingly important domain of policies. It discusses the stimulative effects of budget deficits in the present economic environment, the conditions for debt sustainability and the causes for competitiveness imbalances in the Euro Area. For each of these policy areas, it makes suggestions for the improvement of Europe's economic governance.

Jean-Claude Trichet, President of the European Central Bank
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Nervousness about the sustainability of Greek public debt has pushed the Euro in its first deep crisis. Sharpened by the experience of the recent deep economic crisis, financial markets have reacted to the incoherent crisis management by European governments, the Council and the Commission. The interactions between financial market anticipations, contradictory objectives between governments, policy responses or lack of it, and a general sense of paralysis have created an explosive cocktail of future policy expectations that persists even after the far reaching stabilization agreement made on 9 May. The break up and failure of Europe's single currency can no longer be excluded. Policy makers' narrow visions, their incompetence, coupled with the pursuit of partial and national interests at the expense of European citizens' common concerns, have generated a dynamic that could undo the European edifice. Like in the historic situation prior to World War I, we witness policy actions that could cause an event that no one wanted, but that happened because policy makers collectively failed their responsibilities.

In this paper to the European Parliament I will first outline why the present system of policy coordination is falling short of giving Europe the governance it needs. I will then address the most urgent economic policy issues, namely fiscal policy, debt sustainability and competitiveness imbalance. In the third part, I shall propose

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some practical reforms, which will not solve the long term issues of the European Union's Governance, but could tackle some of its immediate problems and open the perspective to a democratic economic government for Europe.

Europe's collective action problems

The Greek crisis has shown for everyone that Europe's problem is first of all political. Relying on member states' governments to pull the Union out of its difficulties is building the house on sand. It will fail because the incentive logic of collective action will prevent optimal policy decisions. As the representative organ of citizens, the European Parliament will have to assume its democratic role and impose new solutions. Under the Lisbon Treaty it has the power to do so. Before we can discuss what policies should be pursued, we need to understand why Europe has failed in the past.

Europe's economic governance is built on the assumption that each government is responsible for its own economic policies. However, member states are increasingly interdependent so that policy decisions in one country spill over into others and affect citizens who were never able to chose and legitimise them. The idea of national autonomy that was the foundation of the modern nation state has lost its significance in a world of transnational unified markets, free capital flows, technological interdependence, and especially with a single currency. The Treaty on European Union recognises this fact and asks policy makers to consider their national policies as a "common concern".[1] However, the regulatory framework, by which the common concern is translated into reality, is underdeveloped. The Lisbon Treaty assigns different roles to different agencies: member state governments are to coordinate their actions with the Council, the Commission is to promote the general interest of the Union,[2] and citizens are directly represented at Union level in the European Parliament.[3] It also sets a procedure for the interaction of these institutions by specifying how *legal acts* are adopted and whom they bind (art. 289 and 294). Thus, with the Lisbon Treaty the European Union has now the institutional framework, through which it can pass secondary legislation that regulates what is of "common concern".

Half a century of European integration has created a range of public goods that affect all European citizens: common agricultural policy, trade, competition, regional policies, single market, the Euro. These policies have created European public goods in the sense that all European citizens derive benefits from them and that resources and sacrifices are needed to generate them jointly. Unfortunately, because constitutional arrangements have been missing before the Lisbon Treaty was adopted, Europe's institutions have not interacted in ways that would have given citizens the sense that their collective interests are well managed. Too often the common good has been defined by national interpretations of what is "good", and understandably governments have made decisions that accommodated their

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[1] TEU Art 121.1: "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120."

[2] TEU Art 17. "The Commission shall promote the general interest of the Union and take appropriate initiatives
to that end."

[3] TEU Art. 10: "1. The functioning of the Union shall be founded on representative democracy. 2. Citizens are directly represented at Union level in the European Parliament. Member States are represented in the European Council by their Heads of State or Government and in the Council by their governments, themselves democratically accountable either to their national Parliaments, or to their citizens.

national constituencies and not the totality of European citizens. The Greek crisis painfully proves the point. Earlier Greek governments have fraudulently hidden the extent of public borrowing as they were afraid to face elections with an austerity program. Similar behaviour has been found to a lesser extent in most other member states. The unsustainable policies in Greece have had spillover effects (externalities) for all citizens in the Euro Area and even beyond. However, what gave the Greek crisis a special twist was the chauvinist policy debate in Germany that scared the German Chancellor from defending the common currency before the important local elections in North Rhine-Westphalia. Hence, parochial concerns in some member states have generated a crisis, which has affected citizens all over Europe, from Helsinki to Malta, from Bratislava to Shannon.

These policy failures are not caused by lack of political leadership. They are the inevitable consequence of the fractioned intergovernmental polity, in which democratic debates among citizens about what is their common good are blocked because governments negotiate compromises among themselves, pretending that they are the representatives of citizens rather than the European Parliament. This is wrong.[4] National governments are primarily elected to administer national public goods and they are exclusively accountable to their national constituency. They cannot assume responsibility for policies that affect citizens in other states. European public goods need to be regulated at the European level and the process for legitimizing policy decisions of national concern can never be the same as for the common concern of all European citizens. The intergovernmental mode of governing Europe is pre-democratic, because it ignores the political equality of European citizens. It treats citizens as if they belong to states, rather than states belonging to them.[5] Moreover, it also hollows out traditional nation state democracy, because national parliaments *have to ratify* the negotiated compromises, for otherwise their government would lose all authority to deal with other governments. Hence, national parliaments are increasingly deprived of the deliberative function in democracy. To remedy this, the Treaty has given a greater role to national parliaments in the preparatory period of Council decisions, but this makes the problem only worse, for it formally rigidifies partial interests by defining "red lines" without much room for preference change or compromise.

The problem with this intergovernmental form of government is a category mistake: the common interest cannot be served by a part of the whole. In a democratic society, citizens are the principal who owns public goods. As owners of public goods they are all equal, and they are free to collectively appoint a government as their agent to administrate their public goods. Prior to the election of their government, citizens debate what the common good is, i.e. on how they want to live "the good life", their *eudaimonia* as Aristotle called it, and through this process they form their collective preferences. As their agent, governments have to justify the actions taken in the name of citizens and they must give an account of how the collective interest was served. In Europe, this principle applies to national governments, but when national governments make decisions in the Council that affect all Europeans together, it breaks down. Partial interests prevail, the gap of democratic legitimacy increases, and the policy outcomes are suboptimal, because every actor is seeking to maximise his own utility at the expense of others. Political economists call this the problem of collective action.[6]

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[4] See footnote 3 above.

[5] To avoid misunderstandings: policy decisions are about effects for individuals' interests; they have nothing to do with feelings of identity, belonging to a community, etc. In a democracy, "the people" are constituted by their right to vote and nothing else.

[6] Mancur Olson, 1971. *The Logic of Collective Action. Public Goods and the Theory of Groups*. Cambridge, Mass: Harvard University Press.

Collective action problems arise from an incentive structure, which prevents decision makers to simultaneously serve their partial and collective interest. Hence, they generate policy outcomes that are suboptimal for Europe's citizens as a whole. Yet, not all public goods are subject to this logic. There is an important set of public goods, where the individual and the collective welfare are increased, if every decision maker contributes to its realisation. These so-called *inclusive public goods* have dominated the early phases of European integration. Setting up a customs union, or a common market, are decisions which can be made by calculating the cost and benefits for each member state, and if a net benefit can be obtained, all governments have an interest to participate in the common endeavour and play by the rules, because the positive output justifies compliance.

The idea, whereby "we are all better off if we cooperate", has been so dominant in building the European Union, that it is often overlooked that Europe has now generated an increasingly important set of so-called *exclusive public goods*, where this logic no longer applies.[7] In this domain, member state governments serve their interests better by doing the opposite of what they want their colleagues to do. Fiscal policy in monetary union is a perfect example for this. Because the central bank limits the supply of money in order to maintain price stability, money is scarce and demand for funds pushes interest rates up in capital markets. Hence, the Stability and Growth Pact seeks to restrain government borrowing. If all member states were to balance their budgets, interest rates in capital markets would be low, mainly reflecting demand for funds in the private sector. However, for each individual government it would be attractive to borrow at these low interest rates, rather than to increase taxes or cut expenditure. But if each state followed this partial interest, interest rates would go up, damaging every one. Hence, in this case, partial and collective interests diverge and policy realisations are suboptimal. The logic of exclusive public goods dominates many macroeconomic policies in monetary union, but also structural reform policies: the whole Union may gain, but individual member states may benefit from implementing them only after everyone else has done so and if everyone thinks that way, nothing gets done or at least progress is slow. For example, liberalising the energy market may generate economies of scale, which are good for everyone, but if my partners liberalise before me, I may obtain extra benefits by extending my operations in their market while preventing them to come into mine. Hence my industry reaps the benefits of scale, but my competitors do not.

Policy making with exclusive public goods poses many new challenges, which have not been thought through seriously.[8] The easy solution is to call for more policy coordination. For example, the Commission has drawn the conclusion from the recent crisis that a reinforcement of economic policy coordination is needed.[9] However, while this is certainly a convincing argument, few policy makers address the issue why policy coordination has failed in the past and how the collective action problem may be overcome. It is time that Europeans asked themselves, why

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[7] Se stefan Collignon, 2004. Is Europe going far enough? Reflections on the EU's Economic Governance. In: *Journal of European Public Policy*, Vol. 11.5: 909-925 (download from www.stefancollignon.eu).

[8] But see my see my books: *Pour la République européenne* (avec Christian Paul); Odile Jacob, Paris, 2008 ;
Viva la Repubblica Europea!, Editore Marsilio, Venezia, 2008; *Bundesrepublik Europa? Die demokratische Herausforderung und Europas Krise*. Vorwärts Verlag, Berlin, 2007 ; *Vive la République européenne*; Éditions de La Martinière, Paris, 2004; *The European Republic. Reflections on the Political Economy of a Future Constitution*, The Federal Trust, London, 2003

[9] http://ec.europa.eu/economy_finance/articles/euro/documents/2010-05-12-com(2010)250_final.pdf

they fail continuously to implement policies that would serve their common interests.

Policy coordination has been defined as "a significant modification of national policies in recognition of international interdependencies."[10] However, there is a wide spectrum of meanings to the term. We may distinguish at least five forms of cooperation depending on how binding a cooperation agreement is.

1. *Cooperation only by exchange of information* is the weakest form. Policy modifications result from insight and voluntary changes in the preferences of actors. The European Commission seems to believe that insufficient information is one of the main causes for the recent crisis and emphasises the need for better surveillance and setting up a "European semester" where "a system of early peer-review of national budgets would detect inconsistencies and emerging imbalances".

2. *Coordination as crisis management*. An *ad hoc* reaction may prevent clearly perceived negative consequences from not cooperating. This was the logic behind the European Stabilisation Mechanism, set up on 9 May 2010. While this form of coordination may be appropriate to prevent damage from citizens, it stands on weak procedural legitimacy. In Germany, a group of eurosceptic politicians and academics have already asked the Constitutional Court to stop the government from making loans to other governments in the Euro Area.

3. *Coordination by targets*. This requires negotiations between actors who focus on specified variables as surrogate for coordination, but leave it to the discretion of coordinating partners how the targets will get achieved. This is the underlying logic of the "open method of coordination" that emerged from the Lisbon Strategy. It produced few results.[11] The focus on targets ignores compliance. It hopes and assumes partners will do what they say, but it does not deal with incentives and inconsistent *actions*. The Commission now wants to use this approach to "develop a scoreboard of indicators to identify alert thresholds for severe imbalances" and set "more ambitious budgetary targets". While this approach may be useful to make policy orientations more coherent, it is unlikely to produce better results than the Lisbon Strategy. European policy makers should reflect more on the question *why* the open method of coordination has failed to achieve so many targets.

4. *Partial coordination*. Partners agree on policy assignment to specific actors, although not all partners have to do the same thing. Under this approach, it is possible to formulate more binding constraints and even to impose sanctions. Examples are making the Stability and Growth Pact more "flexible" by giving different targets according to structural policy parameters, like aging dynamics, or having different degrees of strictness in the excessive deficit procedure depending on how far public debt exceeds the 60%-mark of GDP. However, the question remains, how binding policy

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[10] P. Mooslechner and M. Schuerz 1999: International macroeconomic policy coordination; *Empirica : Journal of Applied Economics and Economic Policy,* Vol 26.3; Austrian Institute of Economic Research

[11] Stefan Collignon. *2008.* Why Europe is Not Becoming the World's Most Competitive Economy. The Lisbon Strategy, Macroeconomic Stability and the Dilemma of Governance without Governments*; International Journal of Public Policy*, *Vol. 3, Nos. 1/2, 2008.* http://www.stefancollignon.de/PDF/NewLisbonStrategy_8nov.pdf

rules can oblige democratically elected governments to do things they have not been elected to do.[12]

5. *Full coordination*: a bargain across *all* targets and policy instruments that binds all actors, because individual policy makers will only get substantial gains by trading off less relevant policy issues. This is the usual process in democratic legislative processes, where political parties bundle policies into programs, which are then chosen by citizens.[13] However, in an intergovernmental context, the bargaining between governments prevents the formulation of collective preferences because citizens do not have an opportunity to choose. In Europe, bundling policy issues into a coherent program and submitting alternative platforms for the approval by voters has not really happened yet, although Treaty negotiations between member states do cover a broad range of policies. This will change, as the "ordinary legislative process" (art. 294) becomes a more frequently used tool for policy coordination in the EU.

Notice that delegation to a single institution, like in the case of monetary policy, is not coordination, because the responsibility for policy design and implementation is unified in the hand of a single agent, who is accountable to the principal. The Treaty specifically allows such policy making delegation through legislative acts.[14]

These different forms of cooperation need to be applied to very specific policy issues: there are horses for course. Soft methods of policy coordination are appropriate for inclusive public goods, but for exclusive public goods either hard constraining rules are necessary, or delegation to a single authority. Hard rules must be applied in deterministic environments, where the same rule always produces the same results. However, when policies must respond to unforeseen shocks, policy delegation to a unified authority is required, because only such "government" can act with the discretion and moderation required in the circumstances.[15] Monetary and fiscal policies are the archetype for such discretionary policies. The Euro Area has already centralised monetary authority in the ECB and this bank has proven extremely successful in responding to the unforeseen shocks of the recent crises. The € 750bn Stabilisation Mechanism decided on 9 May would never have happened without the urgent warnings and detailed analysis made by the ECB. What is missing is the economic government that could define coherent economic policies, other than monetary, and ensure their implementation.

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[12] In the case of Greece, one may argue that the lack of information and the urgency of the crisis required a redefinition of the program on which the Papandreou government was elected. However, if there is no urgent crisis, how can overruling the democratic choice of the people be justified? This is the question, European policy makers avoid. Yet, they know. When the Commission President Prodi demanded France to reduce the structural deficit created by tax cuts, President Chirac is known to have said about him: "Does he not know that he is only a high civil servant?"

[13] The Lisbon Treaty recognises this role also for the European Union: TEU, art. 10 says: "3. Every citizen shall have the right to participate in the democratic life of the Union. Decisions shall be taken as openly and as closely as possible to the citizen. 4. Political parties at European level contribute to forming European political awareness and to expressing the will of citizens of the Union."

[14] *Article 290:* "1. A legislative act may delegate to the Commission the power to adopt non-legislative acts of
general application to supplement or amend certain non-essential elements of the legislative act."

[15] Stefan Collignon, *Is Europe going far enough? Reflections on the EU's Economic Governance*. In: *Journal of European Public Policy*, 2004 Vol. 11.5: 909-925. http://www.stefancollignon.de/PDF/Far%20enough.pdf

Such an economic government does not require a change in the Treaty. It can be done within the existing institutional framework. Two options are on the table. The idea of economic government was first drafted by French policy makers before monetary union started. It was rejected by the German government, which had previously suggested a political union. It feared that the economic government was a device to undermine ECB independence. Unfortunately, the French government never spelled out concretely what it meant by economic government, and what responsibilities it should have. Many observers suspected that France wanted to run the show. However, since the economic crisis, positions have evolved. Now, even the German Chancellor Angela Merkel has called for an economic government, although specifying immediately: "The economic government is us" (namely the European Council). This approach will fail. The incentive structure of intergovernmental cooperation for macroeconomic policies and the partial legitimization of what should be the European common good will always prevent the realization of optimal policies for all. The other option is to foster the evolution of a European government by using art. 294 and the procedure for ordinary legislation (restricted to the Euro Area)[16]. The European Commission would become the economic government by its right to initiate legislation; the EP represents citizens' interests after debating the common good. The Council would express the legitimate concerns of states and deal with the spillover of European into national policies. I will now discuss how this could be done concretely with respect to budget and debt policies and macroeconomic imbalances, the main concerns in the recent Commission communication. I will argue that fiscal policy requires a unified policy stance in the Euro Area, but wage bargaining could be improved by softer coordination through indicators and better flow of information.

Economic Policies After the Crisis

Fiscal policy

Europe's fiscal policy must respect the norms of the Excessive Deficit Procedure (not more than 3% of GDP for deficits, not more than 60% for debt), which apply in "normal times" as defined by the Treaty. For the Euro Area as a whole, the imperatives of the Excessive Deficit Procedure have been respected, but individual member states have frequently violated the EDP norms. Given the incentive structure for fiscal policy in monetary union, this is not surprising, but it shows that in this domain setting targets and counting on peer pressure for implementation is not enough.

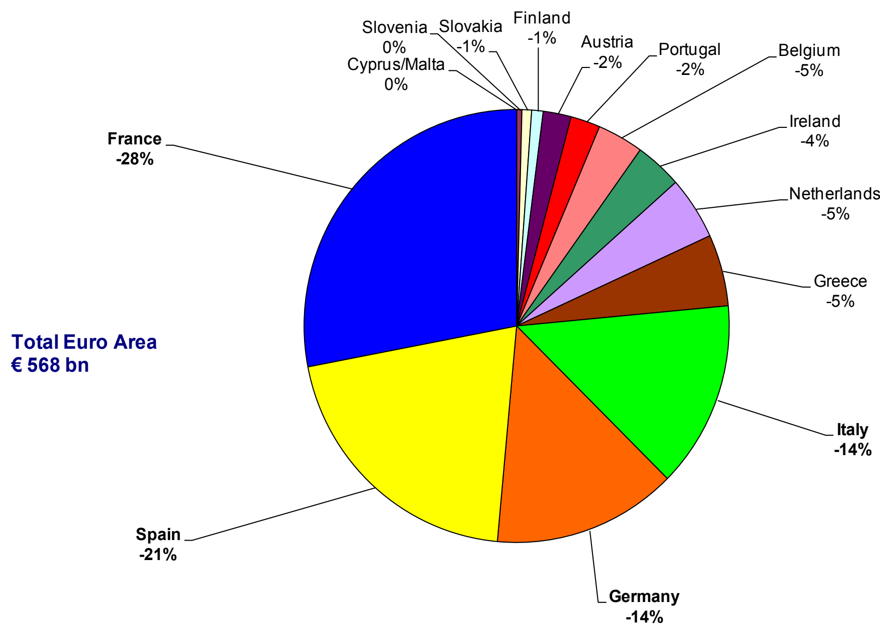
In the course of the crisis, budget deficits have risen to the 5 percent level, where they have now stabilized. In the United States, new government borrowing is twice as important as in the EU, going beyond the 10 percent level, and in Japan it has reached similar proportions. Among the member states of the European Union, only Bulgaria, Estonia, Hungary and Malta have remained within the 3 percent deficit target during the recent crisis. Borrowing requirements have shot up most dramatically to beyond 10 percent of GDP in Greece, Ireland, Spain, Latvia, Lithuania, and in the UK. In the Northern countries, like Austria, Germany, Finland and the Netherlands, fiscal *deterioration* has been significantly lower than in the Southern countries, although the borrowing requirements *in absolute terms* are hardly much different between North and South. Figure 1 shows that, out of a total new borrowing of € 568 billion, Germany's share of borrowing in the Euro Area is exactly as high as Italy's, while France borrows as much as both these countries together. The borrowing requirements are also of similar size for Greece and the Netherlands and for Portugal and Austria. Hence, the relatively stronger

[16] See Consolidated TEU, art. 5, art. 136-8.

deterioration of public finances in the South has brought them closer to the North's position; in sin all men are equal.

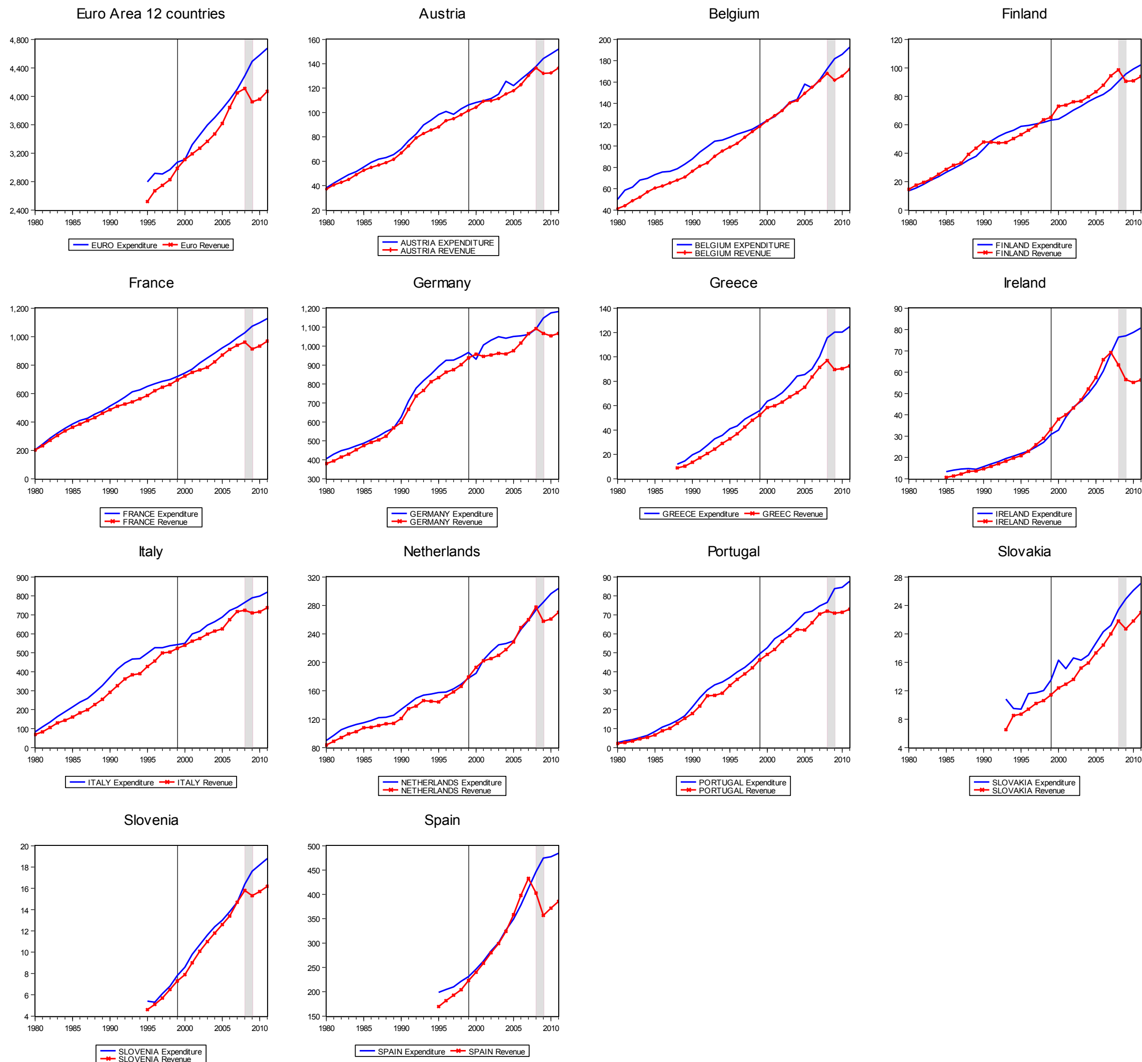
The dramatic deterioration of public finances was the immediate consequence of the deep recession, which has shrank the tax base in all member states. Figure 2 shows government revenues and expenditure in the Euro Area, Figure 3 for non-Euro Area countries, all in local currency. Deficits have increased suddenly and dramatically during the crisis, mostly because of a fall in revenue. Expenses have risen only in Portugal, Finland and Germany, and in Denmark and the UK; outside Europe, the United States and Japan witness a noticeable rise in public expenditure. Re-igniting economic growth is therefore a *conditio sine qua non* for balancing budgets.

Figure 1. Share of Member States' Net Borrowing in Total Euro Area Deficit *(2009)*



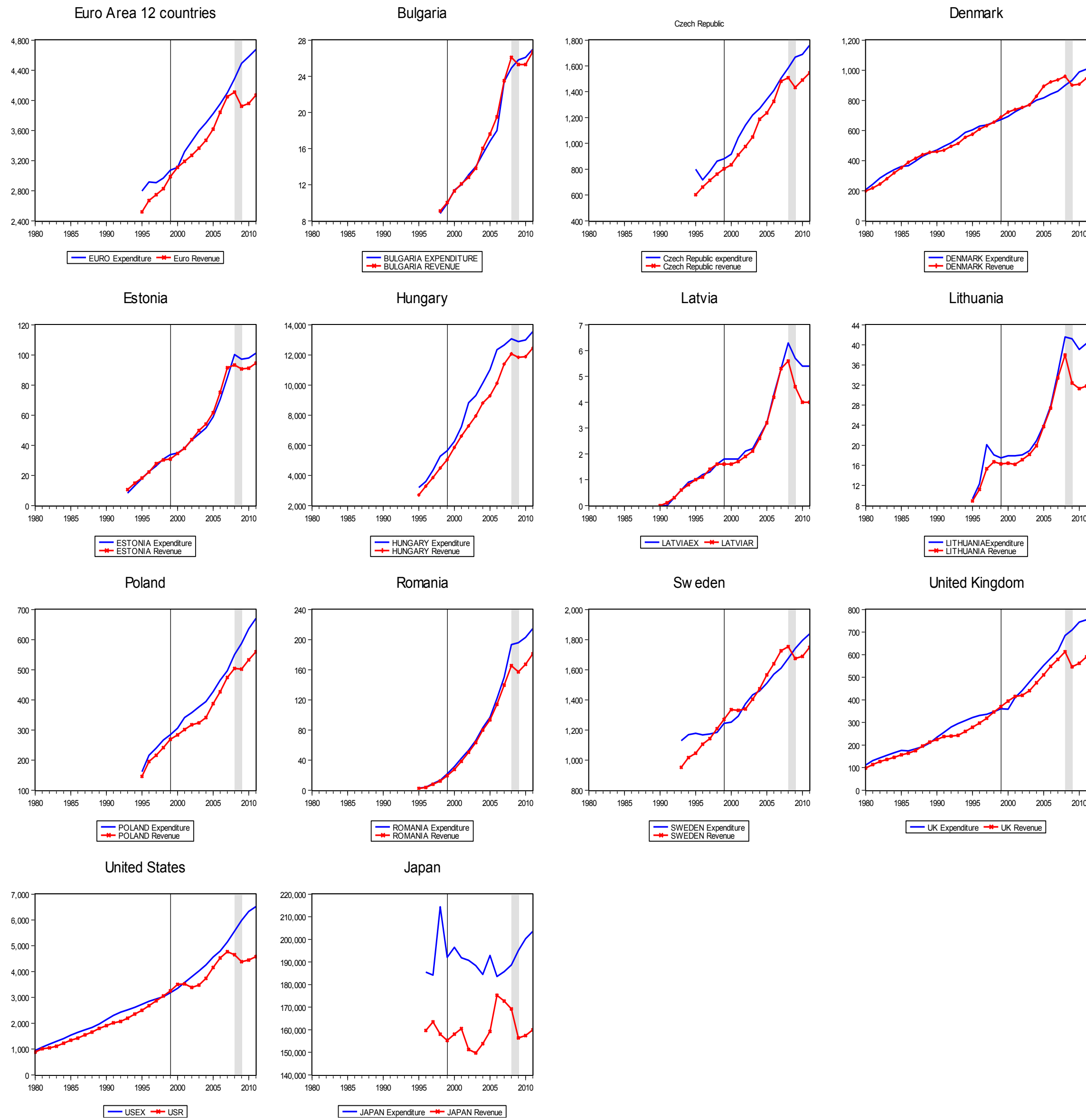
The high deficits have become a stabilizing factor for aggregate demand. Employment losses would have been far worse without these deficits. It is clear from Figure 2 and 3, that when economic growth returns, revenue will rise again, and deficits will close - provided the income is not weakened by tax reforms. However, as the Commission rightly points out, growth may not become equally strong across all member states, because the tax bases may have been affected by asset price inflation. This problem will require structural adjustment to fiscal policies. In the short run the most important policy focus must be to speed up GDP growth. Once the EU comes out of the crisis and GDP exceeds previous levels, long term sustainability issues and structural reforms need to get tackled, but not before.

Figure 2. Fiscal Positions in the Euro Area



In this context the question is not whether deficits are excessive, but when is it appropriate to start budget consolidation? The answer should be: when reasonable growth has returned. This is the task for macroeconomic policy. Economic growth depends on investment, and private investment on interest rates and aggregate demand. These variables are determined at the level of the currency area as a whole through the interaction of monetary and fiscal policy. Monetary policy always interacts with fiscal policy, even if the central bank is independent, because the ECB sets interest rates and because money supply is composed of credit by the banking system to governments as well as the private sector. However, Figure 4 shows that credit to government is a small component of money creation in the Euro Area.

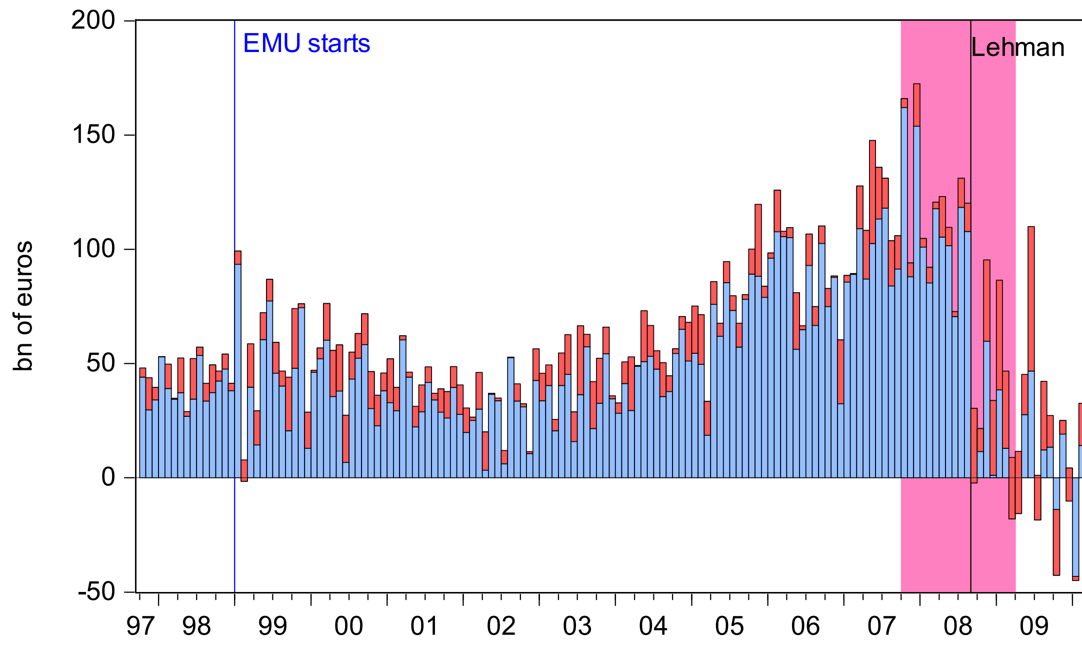
Figure 3. Fiscal Position in the Non-Euro Area



With the outbreak of the financial crisis, especially after the Lehman bankruptcy, credit by the banking system collapsed. M3, the monetary aggregate which is related to inflation expectations, actually fell, because in the climate of great uncertainty banks preferred to hold cash balances with the ECB and private sector demand for new credit disappeared. The only impulse for credit demand came from the public sector after the stimulus package was disembursed. See Figure 5.

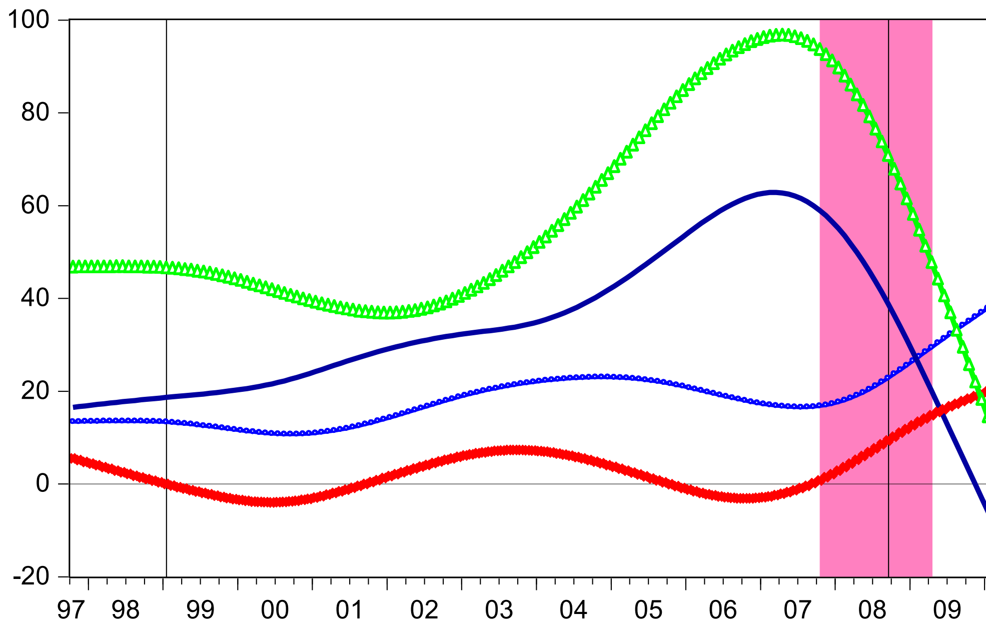
Note, however, that the counterpart of money supply is credit demand from the Euro Area as a whole, i.e. from the private sector and from all governments together. Stimulating the euro economy depends on the *aggregate* fiscal policy stance. It is practically impossible for individual member states to use budget deficits to stimulate "their" economy, because in the single market a large percentage of the stimulus translates into imports from other member states. In addition, some of the stimulus will dissipate to the rest of the world. On average nearly a quarter of the Euro Area's GDP is spent on intra-EU trade, approximately half of aggregate government expenditure. Another 13% of GDP are spent on imports from outside Europe. An uncoordinated fiscal stimulus by member states

Figure 4. Credit Components of M3 (monthly data)



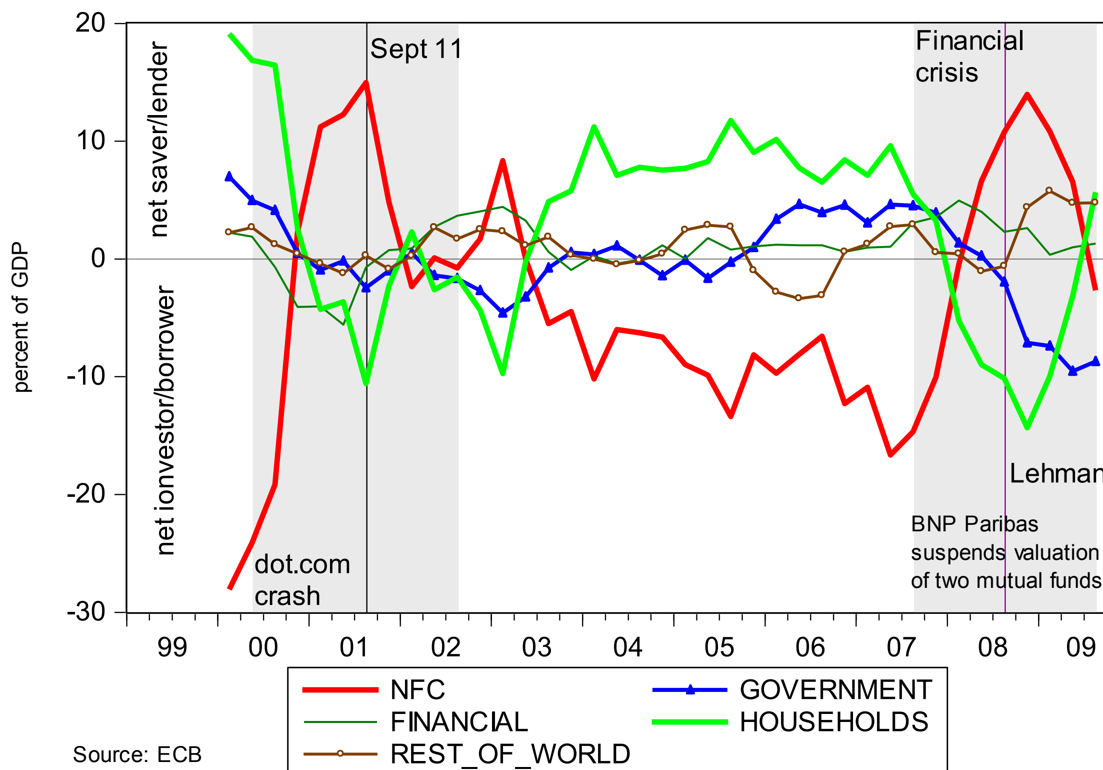
Source: ECB

Figure 5. Trend Growth of M1 and Credit Components



would therefore increase a member state's debt, and give trade partners a free-ride. For this reasons fiscal policy has effectively become a European public good that affects all citizens, at least in the Euro Area, and that needs to be managed at the European level. The Stability and Growth Pact does not allow such aggregate management. I will make a proposal below, how this could be achieved.

Figure 6. Euro Area: Financial Surplus or Deficit by Sector



Instead of flexible and coordinated fiscal management for the Euro Area, we witness a rush to impose fiscal consolidation on all member states in order to meet the Excessive Deficit criteria. Is it reasonable? During "normal" times, firms borrow savings from households, while the government sector and the rest of the world should be in equilibrium. Against this benchmark, Figure 6 shows how extraordinary recent developments have been. The Euro Area has experienced already two asset bubble crises: one after the dot.com crash in 2000, followed by the September 11 shock in 2001, and one starting with BNP Parisbas suspending its mutual funds in 2007 and then accelerating with the Lehman collapse in 2008. In both crises, firms stopped borrowing and started to pay back their debt, while households became net borrowers. Thus, in Europe private wealth is the direct mirror of the corporate sector.[17] The public sector and the rest of the world were close to balance. Governments borrowed less in the first crisis than in the second. The Euro economy recovered in the middle of the decade and the corporate sector borrowed actively as investment and growth improved. When the second bubble burst in 2007/8, the credit collapse was contained, because households and government borrowing exceeded corporate savings after the Lehman crisis, and the Euro Area started to borrow savings from the rest of the world. The demand stimulus seems to have generated some appetite for companies to borrow and invest again, although their

[17]This was different in Japan during the post-bubble years, where government borrowing has compensated for debt repayments by the corporate sector and thereby preserved household wealth.

"animal spirits" are still very weak and far from the borrowing of 10% of GDP which prevailed in the corporate sector during the middle of the decade when Europe generated massively jobs. Hence, it is too early to withdraw the fiscal stimulus and consolidate public finances.

The sustainability of European debt

High budget deficits risk creating unsustainable debt positions over time. However, the debt-GDP ratio not only depends on fiscal policy but also on the nominal growth rate (the sum of economic growth and inflation rates). In most countries, the debt position has started to rise with the outbreak of the financial crisis. The Euro Area as a whole had previously attained its peek at 74 percent in the mid 1990's, and then it has gradually come down below the 70 percent margin. But after the outbreak of the financial crisis it has shot up again, and it is now expected to come close to 90 percent in 2011.

According to the Treaty, each member state should aim to keep its debt/GDP ratio below 60 percent. Only 12 countries out of 27 have fulfilled this requirement, namely Bulgaria, the Czech Republic, Denmark, Estonia, Finland, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Sweden. Major Euro Area members, like France and Germany, have persistently let their debt levels rise for over a decade. In Belgium, Italy and Greece the ratio exceeds 100 percent. There is remarkable diversity in debt levels across Europe and this has not been a major source of instability in the past.

Nevertheless, the explosion of public debt is worrisome for a number of reasons. First, with rising debt levels, the debt service is becoming more burdensome, and this may cause snowball effects that will increase the debt ratio further. Secondly, the rising debt service is a form of redistribution from the broad level of tax payers to the few owners of government debt. It therefore creates social distortions, which are socially unacceptable and could undermine the credibility of European fiscal policy rules. Third, as the burden of the debt service is increasing, fiscal adjustment needs to become more radical, and this may render the return to sustainable deficits over the medium term much more difficult. This problem is particularly hampering the Greek consolidation process at the moment.

Under what the conditions is public debt sustainable? Is there a risk for Europe's debt to explode? The answer is no, but the proof is complicated and I will give here only the main insights.[18] We think of fiscal policy as a set of rules applied to a given level of debt. If a government borrows to service its debt, the debt-GDP ratio would increase until tax payers become unwilling to pay interests to bondholders. The government is then insolvent. Sustainable debt requires that debt eventually converges back to a stable equilibrium level, but the size of this level is a priori undefined. Debt is sustainable, when the present value of discounted future primary surpluses is sufficient to reimburse the value of public debt.[19] This describes a situation, where no major changes of policy are needed to ensure the solvency of a government.

The fiscal policy rules are defined by the Excessive Deficit Procedure (EDP). If the reference values of 3 and 60% for deficits and debt are not met, member states have to make extra consolidation efforts to bring deficits back into the acceptable range. These two rules regarding deficits and debt are consistent, as long as the

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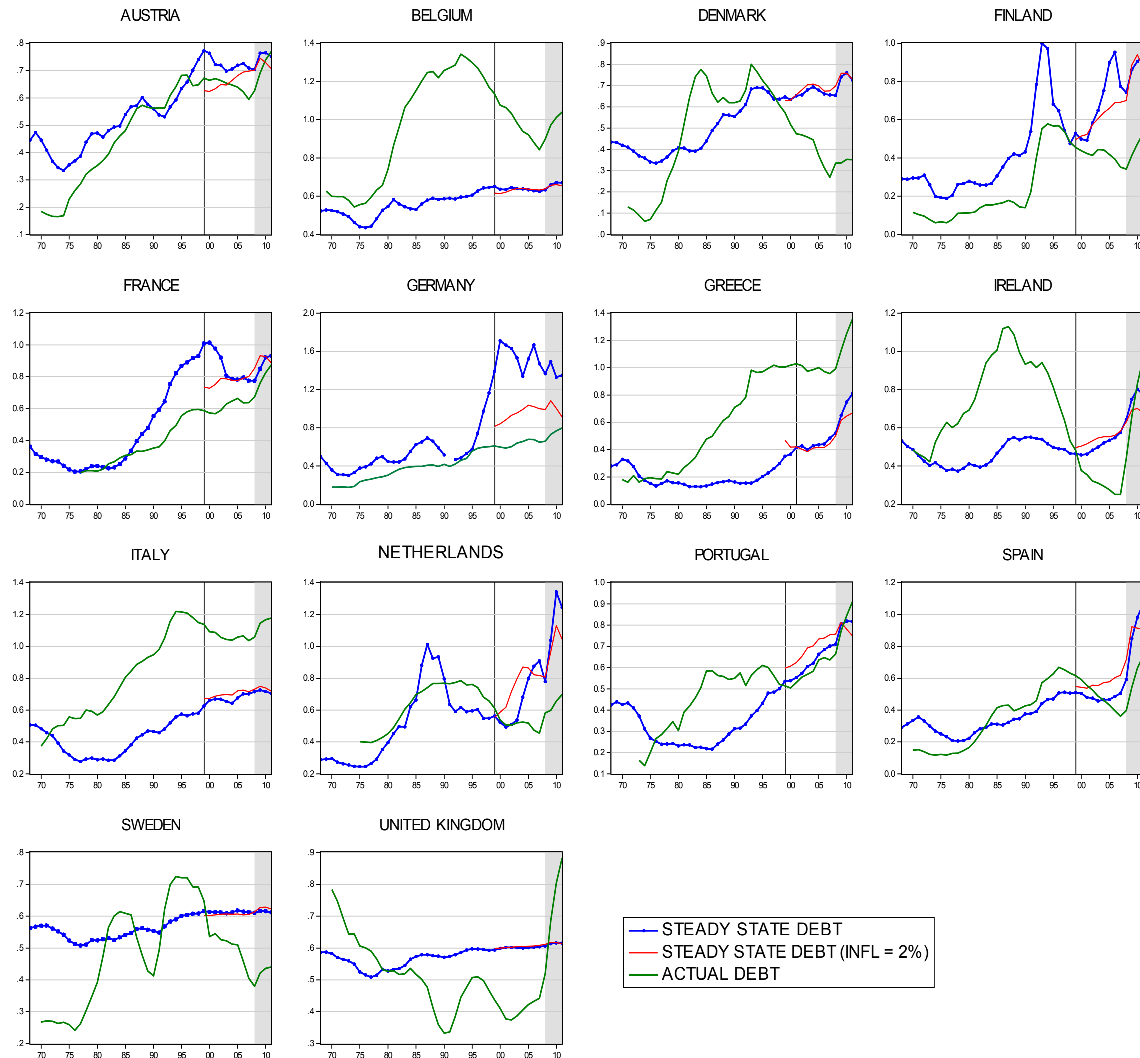
[18] For details see www.stefancollignon.eu

[19] See Blanchard, Chouraqui, Hagemann and Sartor, 1990.

economy grows at a nominal rate of 5 percent.[20] If growth is less, the ratio will rise. However, the rules do not specify, how quickly deviations from the rule must be corrected. The EDP only sets procedural rules, but how much effort governments make is up to them, although the Commission and the Council are supposed to supervise them. In actuality, it takes years until debt levels come down to the reference value. There used to be little debate on how much consolidation effort is necessary to ensure long run sustainability, but the Commission now is putting this topic on the agenda. In this context, one may osverve a simple rule that guarantees sustainability.

Figure 5. Public Debt in the Steady State



We assume that a government has two ways to react to an excessive deficit: it may correct the excess borrowing by bringing the deficit down by a fraction alpha of what is required to reach the target. For example if the deficit is 4 percent, while the target is 3 percent, alpha=0.5 means the budget correction is 1/2 percentage point of GDP. Similarly, β is a coefficient for correcting the excess of the debt ratio

[20] The long run debt/GDP ratio is defined by d=def/(y+p); where d is the debt ratio, def the deficit, y the growth rate and p the inflation rate. Assuming economic growth of 3 percent, inflation of 2 percent and a deficit of 3 percent yields a debt ratio of 60 percent.

over 60 percent. In the past, European fiscal policy has mainly focused on alpha, but in its recent Communication the Commission suggests giving greater attention to beta. Estimates show that alpha is on average around 25-33%, with Germany the highest (75%) and Denmark the lowest (13%).[21]

When we combine the fiscal policy rule with the factors that determine the dynamics of debt ratios, we get a system of two differential equations which can be solved and yield the following insight. First, the long run equilibrium debt ratios are not stable, but depend on the policy targets (3% for deficits, 60% for debt), on policy reaction coefficients alpha and beta, and on the nominal growth rate of the economy. Figure 5 shows the evolution of the steady state equilibrium debt ratio for selected European economies and compare it to the actual debt ratios. We observe that the equilibrium ratios can vary substantially, largely as a function of economic growth and inflation. In most, but not all, member states did the equilibrium debt rise as a consequence of the economic crisis. In some member states, like Finland and Germany, it could be significantly lower, if their inflation rates would match the ECB target of 2%; in others, like Spain, the ratio would be higher. However, the most worrisome aspect is how far actual debt ratios can deviate from the equilibrium and how long it takes to converge to it.

This leads us to the second question, namely whether actual debt rations have a tendency to converge to the steady state, or do they explode? The mathematics to answer the question is not trivial, but the simplified solution is that the policy adjustment coefficient alpha must be larger than the difference between the interest and the growth rate.[22] Estimates show that this has always been the case over the last 30 years and that the Stability and Growth Pact has not modified policy behavior by member states. However, the sustainability of public debt depends crucially on the difference of interest rates on debt and the economic growth rate. It determines the burden to tax payers and therefore ultimately their willingness to service the debt. Figure 7 shows that in recent years, the growth-adjusted interest rate has been close to zero. This position needs to be maintained. Monetary policy is contributing to this, but most important is maintaining growth.

Hence we can conclude that from the point of view of modern economic theory, long run debt levels in Europe are sustainable, although it may not look that way from a short run perspective. However, this is a problem when theory meets the market. If debt levels are rising, even if they are sustainable, governments need to raise additional funds and short-sighted markets may get worried and refuse to buy new government debt. This is what has happened to Greece. The answer to this problem is twofold: governments must attach greater attention to debt management with the purpose of smoothing the maturity of government bonds. Second, Europe needs deep and liquid sovereign bond markets. Policy proposal II explains how this can be done.

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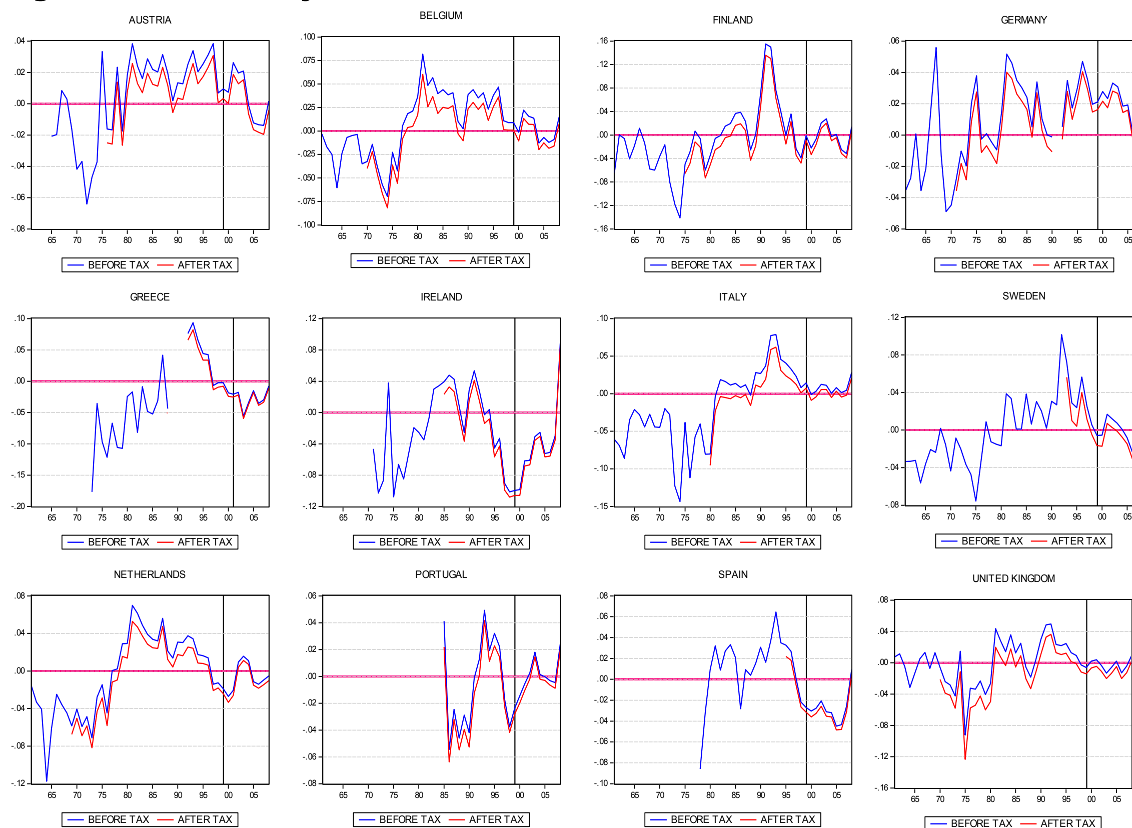
[21] See Centro Europa Ricerche, *Report on Europe 2010, Europe adjusting to the Crisis*, Roma (download from www.stefancollignon.eu).
[22] See S. Collignon and S. Mundschenk, 1999. The Sustainability of Public Debt in Europe; *Economia Internazionale* 1999 – Numero Speciale, Supplemento al Vol. LII, Num. 1, Febbraio. http://www.stefancollignon.de/Download06.htm

Figure 6. Growth Adjusted Real Interest Rate



Source: AMECO

Competitiveness and macroeconomic imbalances

Over the first decades of the euro, large current account imbalances have accumulated and many observers have expressed concern about this development. The European Commission services have provided an excellent analysis for the underlying causes and factors.[23] The bottom line argument is that sustained current account deficits can be a sign of catch-up growth or of deteriorating competitiveness. I will concentrate here on the issue of unit labour cost competitiveness. However, we should first clarify some misperceptions.

The current account balance is the difference between domestic savings and investment and a deficit signals that capital inflows (i.e. foreign savings) supplement domestic savings. This transfer of foreign resources lowers a country's net foreign assets or increases its external debt. When foreigners are no longer willing to lend, or withdraw funds, a deficit country runs out of reserves and this fact is the ultimate constraint on the resource balance. In monetary union, however, the resource balance applies no longer to individual member states, but to the monetary economy as a whole, because foreign exchange reserves are held by the central bank and any commercial bank, regardless of its location, has unrestricted access to it. Thus, the common and unrestrained access to central bank money abolishes constraints on *national* resource balances, because individual member state economies cannot run out of reserves. Only the current account for the Euro Area as a whole matters for the savings-investment balance: within the

[23] Quarterly Report on the Euro Area, 2010, vol 9.1: http://ec.europa.eu/economy_finance/publications/qr_euro_area/2010/pdf/qrea201001en.pdf

Euro Area, the ECB controls money supply and sets the budget constraint for the banking system. Households, firms and governments keep their savings with commercial banks, which allocate these financial resources to the most profitable projects, regardless of where the investment opportunities are geographically located. In other words, the European banking system collects the total amount of savings in the Euro Area and redistributes it according to risk-return considerations.

Hence, the idea that member states should balance their current accounts within the Euro Area is misguided. A current account deficit in less developed regions can be a sign for catch-up growth, if capital inflows fund attractive investment opportunities. It could also indicate a loss of competitiveness, if regional unit labour costs are higher than in partner states. In the first case, the current account deficit is desirable, in the second it is a sign of weakness. A "good" current account deficit is correlated with economic growth, a "bad" one with stagnation. The same is true for government borrowing. If public debt finances investment, it may accelerate growth and increase the current account deficit; but if the government borrows for consumption purposes, it may slow down economic growth. Table 1 gives an indication for the different positions of EU member states. However, when government deficits rise because economic growth is hampered by the loss of competitiveness, public debt will become unsustainable. Financial markets may then no longer be willing to fund sovereign debt because they worry about defaults caused by insufficient revenue. The way out is then to improve competitiveness by rising productivity.

Internationally, cost competitiveness varies with exchange rates, but in monetary union, there are no exchange rates. For the Euro Area, we must therefore look at the evolution of unit labour costs as the main indicator for competitiveness. The Macroeconomic Policy Dialogue has formulated a soft rule, whereby nominal wage increases should not exceed productivity gains plus the ECB inflation target. Unit labour cost is defined as the level of nominal wages relative to productivity, hence the amount of euros spent on labour to produce one unit of output. Figure 7 shows the evolution of ULC levels since monetary union started.[24] It appears that the average increase in Euro Area ULC have been modest, with 1.5% well below the ECB inflation target. Nominal wage restraint has contributed to the overall price stability of the euro, while changes in unit labour costs are largely driven by variations in labour productivity.

However, between member states significant divergences persist. Unit labour costs in the South have been rising, in the North stagnating or even falling. Portugal has unabatedly persisted with high unit labour cost increases. Spain, Greece and Italy have also had rapid increases in ULC, moving from below-average to above-average labour cost levels. Today, Portugal, Spain, Italy, and Greece are the most expensive labour locations in Europe (we consider Luxemburg with its high banking concentration as a special case). The opposite is true for Germany. It first kept unit labour costs stable, while they were rising in the Euro Area; unit labour costs then actually *fell* in absolute terms after the Hartz-reforms started to bite. Today Germany is the cheapest labour cost location in the Euro Area. Finland has maintained its initial competitive advantage, at which it entered the euro. Austria has followed the German wage trajectory until Germany started to go against the stream of all other Euro member state. The financial crisis has slowed down this

[24] The relative levels were calculated by assuming real ULC, i.e. the wage shares in 1999 reflected the starting competitiveness positions in 1999. Quarterly data for Portugal are not available, but annual data show Portugal to be the country with the highest ULC in the Euro Area. See Collignon, 2009. *Wage developments in Euroland or: the Failure of the Macroeconomic Dialogue*; http://www.stefancollignon.de/PDF/WagedevelopmentsinEuroland34.pdf

divergence, mainly because it reduced productivity in Germany (due to *Kurzarbeit*), and improved it in some southern countries, especially in Spain (due to high unemployment). However, there is little evidence for structural change in wage bargaining behaviour.

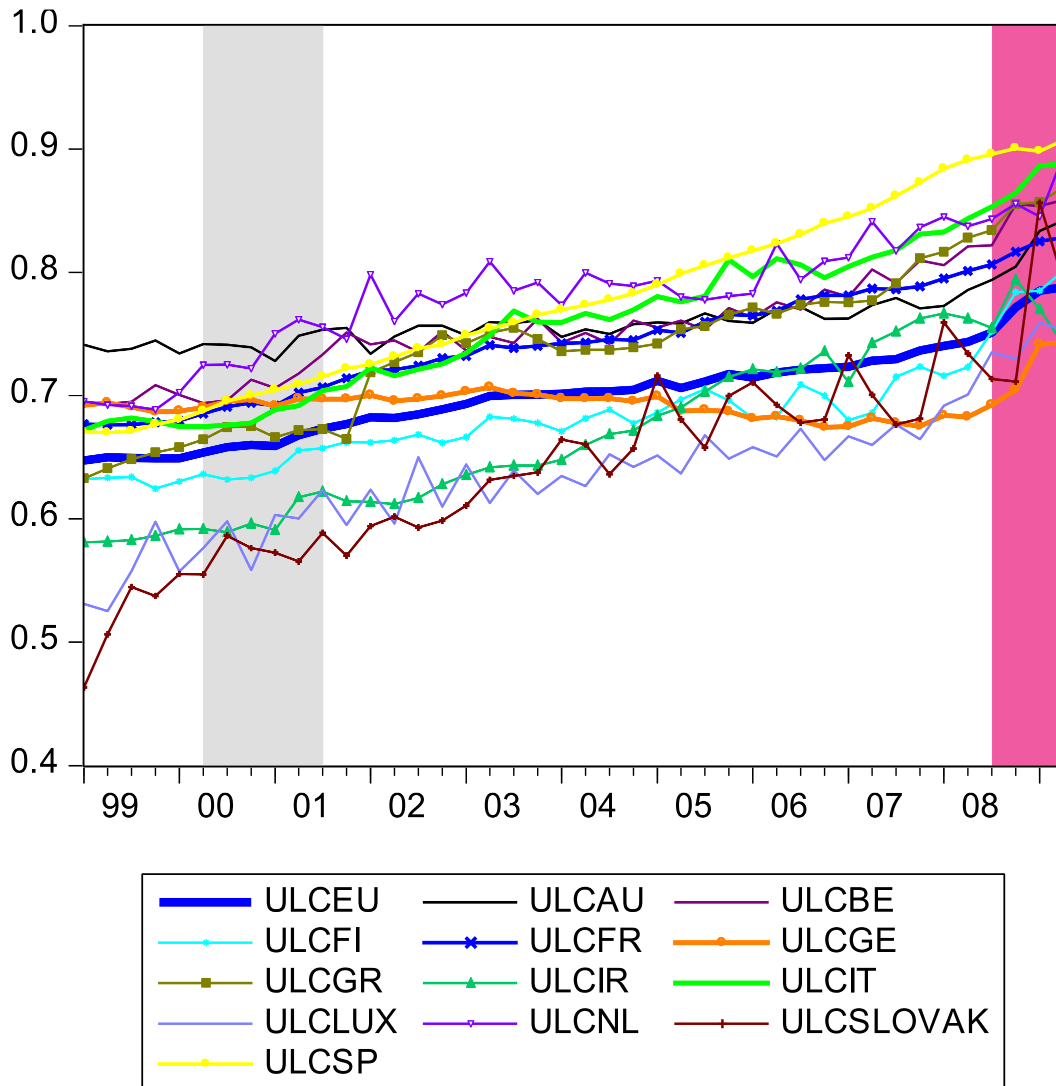
Table 1. Public investment in the EU, 2009

% of GDP			
Euro area	**2.8**	**EU 27**	**2.9**
Austria	1.1	Denmark	2.1
Germany	1.7	Hungary	2.7
Belgium	1.8	United Kin	2.7
Malta	2.2	Sweden	3.7
Slovakia	2.3	Latvia	3.9
Italy	2.4	Lithuania	3.9
Portugal	2.4	Cyprus	4.1
Finland	2.8	Bulgaria	4.8
Greece	2.9	Estonia	4.9
France	3.3	Poland	5.3
Luxembou	3.6	Czech Rep	5.4
Netherlanc	4	Romania	5.4
Spain	4.4		
Ireland	4.5		
Slovenia	4.9		

Deeper analysis reveals that the main cause for diverging ULC levels is the sectoral orientation of wage bargaining leadership. In Germany, wages in the tradable (export) sector set the tone for the other sector negotiations; in the South it is the non-tradable sector that leads with an inward-looking orientation.[25] Thus, there is a case for greater coordination of national wage bargaining with the overall policy orientation of the Euro Area. Wage negotiators must take into account that if they increase nominal wages more than productivity plus the ECB inflation target, they may push the ECB into restrictive mode, which would be bad for employment all over the Union. In the North, they must understand that their behaviour of keeping ULV below the ECB target contributes to excessive increases in the South, because the ECB cannot react to Southern inflation. However, wage restraint in the South is also in wage bargainers' interest, for otherwise the South loses all jobs to the North. On the other side, the North must recognise that increasing wages less than productivity plus inflation target may give them comparative advantages over the South, but slows down demand and growth at home and in partner countries.

[25] See Centro Europa Ricerche, 2009, *Report on Europe: Mastering the Crisis*; http://www.stefancollignon.de/PDF/RapCer_0109_inglese.pdf

Figure 7. Unit Labour Cost Levels in the Euro Area
(1999Q1: nominal = real ULC)



Source: OECD, own calculations

The appropriate form of coordination for wage bargaining, which is characterized by innumerable and highly diversified wage contracts, is to improve the flow of information by opening up national economic debates to the European requirements. This was the intention of the *Macroeconomic Policy Dialogue* (MPD).

It was set up in 1999 and involves not only member state governments and the European Central Bank, but also social partners. The purpose is to facilitate the flow of information between policy makers and social partners, so that wage settlements will not create inflationary pressures (second round effects after negative price shocks) to which the ECB would respond by rising interest rates. But again, the problem with this MPD is the lack of binding commitments on either side of the dialogue. If macroeconomic management is to become more efficient, the institutional arrangements in the Euro area must become more coherent, and decisions must oblige and bind all policy makers. This can only be accomplished if institutions at the European level can command full democratic legitimacy. Policy proposal III makes a suggestion, how this could be achieved.

Policy Proposals for Reforming Europe's Economic Governance

In this section, I will make three proposals to improve the management of the European economy that would take into account the political requirements for overcoming the collective action problems discussed in the first part. They do not envisage setting up an "economic government" *ex ovo*, but realizing them by using the procedures for secondary legislation with the co-decision of the Council and the European Parliament would gradually allow the Euro Area to grow into a reality, where the Commission became the administrator of the economic government, while the Council and Parliament jointly provide democratic legitimacy.

Proposal I: Integrating European and National Budget Policies by Tradable Deficit Permits

A single currency area requires coherent, unified and aggregate fiscal policy stance in order to deal with macroeconomic shocks affecting the whole of the Euro Area. Given that the bulk of expenditure in the EU is allocated by national governments, a mechanism is needed to define the desired aggregate fiscal position (total public expenditure minus revenue). The aggregate fiscal policy stance should reflect the economic conditions of the whole of European Monetary Union, but also national preferences for the allocation of resources. The aggregate policy stance should be determined by a European Directive, subject to the ordinary legislative process. Once the aggregate deficit is defined at the European level, each jurisdiction is assigned a share of this total deficit. Within their assigned quota, national governments are free to set their priorities in response to their voters' preferences.

Technically the procedure of first defining the macroeconomic aggregate and then its micro application in a second step is not unusual. For example, the French Parliament votes first a macroeconomic framework law, so that the subsequent detailed item voting within the overall budget constraint (*les arbitrages*) ensures that specific preferences remain coherent with the overall stability requirement. Similarly, the budget process in Italy defines first the multi-annual macroeconomic framework law, the *DPEF*, and then the *legge finanziaria*, which implements the actual budget allocations.[26] In our proposal, the macroeconomic stance is voted by the European Parliament and the Council, the micro-application by national parliaments.

In the European context, such an instrument could be developed by transforming the Broad Guidelines of Economic Policies (BEPG) defined in art. 121 into secondary legislation. The purpose is to define a binding annual macroeconomic framework law. These guidelines would set the authorised *aggregate* spending and income targets for all EU public authorities (from municipalities to regions, nations and the EU budget), as they seem relevant for the business cycle, but also with respect to intergenerational burden sharing. As such the BEPG would effectively define the aggregate budget deficit of the European Union for any given year. This would ensure vertical flexibility of Europe's fiscal policy.

In order to give these revamped Broad Economic Policy Guidelines binding legitimacy, which entitles the European Union to superimpose budget rules on national parliaments, it is essential that they have full democratic legitimacy. An un-elected Fiscal Policy Committee of "experts" would be totally incompatible with fundamental democratic norms. This is why these Guidelines must take the form of an "ordinary legislative process" (art. 294), in other words it is not enough to let the Council take decision, but the European Parliament must approve it as well.

[26] Amato, G. 2002. *Verso un DPEF Europeo;* NENS No.4 (Nuova Economia Nuova Società), luglio, p.15-19.

Once the aggregate fiscal policy stance has been determined, the respective shares of income, expenditure and deficits have to be allocated to national governments. An obvious benchmark for the allocation of these shares would be the GDP-weight of respective member states. However, this does not take into account asymmetric shocks or heterogeneous preferences for the intergenerational distribution of tax burden. A mechanism is therefore necessary that introduces horizontal flexibility to deal with deviation from the initial allocations without violating the aggregate policy stance.

One method would simply be to leave the authorisation for deviations to negotiations in the Council. No doubt, this solution would delight civil servants in national administrations. A more elegant way could be the introduction of *tradable deficit permits*.[27] Under this procedure each member state would have the right to sell part of its deficit quota to other administrations. If a country chose to borrow more than authorised by its quota, it would have to buy additional deficit permits from countries, which do not wish to use their own quota.

One advantage of tradable deficit permits is their decentralised enforceability. A deficit permit gives the right to borrow, but one could pass a law, whereby banks are legally prohibited to lend to public authorities if they do not have the required deficit permits. Markets are therefore policing fiscal policy out of self-interest. This application can also be decentralised to lower level jurisdictions (regions, municipalities, etc.) as long as they have borrowing authority. National governments would then have to set a domestic procedure for re-allocating their national quota to lower level authorities. This solves one of the vexed problems of "domestic stability pacts", which has been a major obstacle for meeting the Maastricht criteria in federalist states, such as in Germany.

Furthermore, by making these permits tradable, the political option of borrowing versus taxing obtains a price that reflects the relevant scarcity of funds. The procedure therefore invites a public debate about citizens' preferences. It contributes to the democratic decision-making regarding budget policies in Europe and mitigates the tension between aggregate European and partial national interests.

Proposal II: Private Union Bonds

The perception of a rising default risk by the Hellenic Republic has destabilized the Euro Area's banking system. The *European Financial Stabilisation Mechanism* has provided some bridging finance, but if a government would default on its debt after having received credits from other member states, a serious constitutional problem would arise. The Lisbon Treaty, art. 125, states unambiguously that neither the Union nor member states shall "be liable for or assume the commitments" of public authorities in the EU. This means that governments are allowed to make loans to other governments, because it is expected that the lender will get the money back; but if the debt is restructured and part of it is forgiven, lending countries would have "assumed" the commitment and their taxpayers would have become liable for debt in defaulting countries. This is not a banal issue.

The ECB has now announced that it will buy some sovereign debt titles in the open market.[28] These measures are designed to sustain the liquidity of the banking

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[27] Casella, A. 2001. Trade-able Deficit Permits: in: Brumila, A., Buti, M and Franco, D. 2001. *The Stability and Growth Pact, The Architecture of Fiscal Policy in EMU*. London: Palgrave.
[28] "In view of the current exceptional circumstances prevailing in the market, the Governing Council decided:

system and to prevent a systemic meltdown. However, the ECB has not indicated which government bonds it is likely to buy. Given that it seeks to remedy market disfunctionalities, one may expect that it will intervene in securities where yield spreads are large. But this could put the ECB in a weak position. On the one hand asymmetric interventions would distort the bond market, which is supposed to price the default risk for sovereign bonds. On the other side, the ECB could be accumulating debt of low quality and it might, in the end, be sitting on a pile of nonperforming assets if the government were to default.

An elegant solution to minimize these dangers is to pool sovereign risks. Portfolio theory has shown that combining assets with different characteristics in a unified portfolio reduces volatility (uncertainty) and increases returns relative to risk. This stabilization effect could be used to integrate the European bond market and protect government loans against sovereign defaults. This can be done by creating an asset backed security, consisting of collateralized government debt obligations, which we will call private Union Bonds (UB). Union Bonds are issued by a specially designed Union Bond Trust (UBT), which can be set up by private banks and/or semi-public entities. The Trust buys public debt from banks and other investors. The securities will essentially be government bonds, but they could be extended to loans made by governments under the *European Financial Stabilisation Mechanism*. This would remove the risk that governments are liable for other states in case of a sovereign default. The Trust would become the owner of a pool of national debt titles (the collateral). In order to substantiate the notion of European solidarity, the composition of the Trust's assets will reflect the national shares in the ECB capital. Thus, individual government debt titles are the Trust's assets, and Union Bonds are the liability of the UBT.

The UBT sells Union Bonds to investors, which are banks, pension funds, insurance companies, foreign Sovereign Wealth Funds, etc. Government treasuries can also be buyers of Union Bonds. Investors buy Union Bonds and receive payment derived from the income of the collateral according to a defined structure of tranches. This allows pooling the risks and returns of different national debt titles and to structure them so that they reflect the needs and preferences of investors and debtors in. Union Bonds could cover the full range of the yield curve. They are tradable in capital markets, where the overall quality and credit-worthiness of sovereign borrowers is constantly evaluated. Yet, as a portfolio, Union Bonds are less vulnerable to the hazards of international rating agencies because they reflect a weighted average of securities. Union Bonds therefore contribute to the integration of the European bond market.

Potential risks are the *default* of a collateral component, which may affect the debt service (if a borrower suspends payment) and/or the principal (in case of debt restructuring). There is also an *interest* risk, which results from high yield spreads for different national government bonds. If the UBT holds assets with early repayment clauses, there may also be a *repayment* risk. Institutions that sell individual government debt titles to the UBT, such as banks, insurance companies and semi-public entities, will gain by removing potentially non-performing assets from their balance sheets and lower their risk exposure. Given the quality of the underlying assets, Union Bonds should have no problem to be rated in the high A's. Hence they would qualify for European Central Bank collateral in repo transactions

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To conduct interventions in the euro area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments which are dysfunctional. The objective of this programme is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism. (…)" http://www.ecb.int/press/pr/date/2010/html/pr100510.en.html

or in open market operations. This would also serve the ECB by reducing its risk exposure.

The issuance of private Union Bonds could contribute to the denouement of the Greek crisis in three ways. First, it could overcome bottlenecks in funding the Greek adjustment program by bundling newly issued Greek debt of low quality with high quality debt of other member states. This does not mean that governments would issue a joint bond, something that member states with good signatures and low interest rates, like Germany, would understandably resist. In fact, governments would still issue debt on their own, but the UBT would bundle them into the Union Bond portfolio. The advantage is that the fund can provide demand and liquidity for the new issue, which otherwise may be absent. Union Bonds could therefore provide funding during the adjustment period with minimized moral hazard problems, while vigilant markets assess default risks on an individual country by country basis. Second, Union Bonds can reduce the cost of borrowing for governments during the adjustment period, because the UBT will become a major buyer of individual government debt titles. It can thereby prevent that fire sales push yields to excessive levels and would support the sustainability of debt. Third, it could reduce the risks of a banking crisis following a sovereign default, because banks can diversify their risk exposure orderly in advance. These three factors would restore stability in the financial markets and regenerate trust in the euro. Although they may not actually prevent a default, their main advantage is the separation between sovereign and private debtors. Because banks would not have to fear liquidity bottlenecks, they would continue to fund profitable investment opportunities and thereby support economic growth and the sustainability of debt. The transformation of isolated national bonds into securitized Union Bonds would therefore give credibility to the no-bail-out clause in the Treaty of the European Union.

In addition to the stabilizing portfolio effect, some incentives may be needed to ensure the success of Union Bonds. These incentives need to deal primarily with liquidity and risk-return considerations, although one could also consider marginal tax incentives for holders of Union Bonds, if this is politically desired.[29] With respect to liquidity, the most important institutional support is the eligibility of Union Bonds as acceptable assets for monetary policy operations of the Eurosystem. Possibly of greater importance are risk-return considerations. For some investors the average yield of a Union Bond portfolio may seem unattractive. Other may specifically value the risk reduction compared to individual government bond. However, most importantly, having lent money under the *European Financial Stabilisation Mechanism,* governments must be concerned about protecting themselves against capital losses, which could be seen as a debt assumption of other member states' debt in case of a default.

In order to deal with these issues it would be possible to adjust the payment structure of securities issued by the Union Bond Trust as a waterfall. For example, a "principal only" tranche of the Union Bond has highest priority over other debtors in case of a partial default, but it would receive interest remuneration only at the rate of the lowest national government bond (presumably German Bunds). Governments could then buy this tranche and give taxpayers the maximum certainty that they will get their money back. The excess yield from the UBT's income is paid out to investors in the sub-par tranche. Thus, investors buying this tranche would get higher yields, but they would also run higher risks. In order to avoid excesses in

[29] Previous experience with the Ecu, which was a portfolio of national currencies in the European Monetary System, proved that the development of private Ecu markets benefited from capital control exemptions in Italy and France.

the sub-par market, financial regulators could impose prudency rules. Structuring Union Bonds in this way makes it possible to sell Union Bonds to risk averse investors, such as government agencies, and also to more high-yield oriented investors in the private sector. It is an elegant way of avoiding the constitutional problems of a bailout.

Proposal III: Reforming the Macroeconomic Dialogue

The basic norm for European wage bargaining must be that nominal wages increase in line with productivity and the inflation target of the ECB. Temporary deviations between countries and overtime, caused by economic shocks, may occasionally be allowed, but the general trend in wage bargaining must respect this rule. Deviations from the rule should be publicly discussed and justified. In order to increase public acceptance and compliance, which is crucial during wages negotiations, this debate should take place in a transparent, mutual and openly accessible forum.

One should therefore *transfer the Macroeconomic Policy Dialogue from the Council to the European Parliament.* Parliament would invite social partners to regular public hearings on wage negotiations and subsequently make recommendations to social partners and member states governments. These hearings could be coordinated with the auditions of the ECB-President in the European Parliament. Prior to these hearings, national macro-dialogues could still take place within member states, as they do today. This reform would render wage bargaining more transparent with respect to the macroeconomic policy requirements of the Euro area as a whole. It would, therefore, foster a new culture of stability-oriented income policies in Europe. One may also consider whether a more binding mechanism is ultimately required when unit labor costs deviate persistently from trend. This could be modeled on the procedures to impose sanctions under the Stability and Growth Pact. More detailed work and collaboration with social partners is required.