

WEATHERING THE STORM

Fair-weather versus stormy-weather governance in the euro area

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Highlights

- The euro is and will remain a stateless currency. Treaty revisions and failed referendums have buried the idea that it is a stepping stone towards European political union. This has consequences for the euro's governance structure.
- The complex governance structure of the euro area was developed on the assumption that prevention would make crisis management provisions unnecessary. This assumption is now being tested.
- The experience of the crisis shows that the euro-area governance system lacks some crucial properties: speed of reaction, policy discretion and centralised decision-making. These shortcomings have damaged the euro's international status because a question mark has been raised over its effectiveness as a stormy-weather currency.
- The euro has proved attractive as a fair-weather currency for countries and investors well beyond its borders. But it still remains to be seen if its governance is strong enough for it to succeed as a stormy-weather currency.

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Weathering the storm: fair-weather versus stormy-weather governance in the euro area

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The euro has been, is and will remain a currency without a state. Ten or even five years ago many in Europe would have questioned this assertion, because they saw the single currency as a stepping stone towards political union. A few treaty revisions and failed referendums later, however, this perspective has vanished. Even if the Treaty of Lisbon, which includes most of the provisions of the aborted constitutional treaty, is eventually ratified, the momentum has been lost. For all practical purposes the euro must be regarded as an orphan currency.

The governance structure that results from this situation is a complex one. The choices made at the time of the Maastricht Treaty – a monetary union without a significant federal budget, limited coordination of budgetary and structural policies, no integrated financial supervision, no strong political counterpart to the central bank – were regarded by many of its architects as temporary. Over time, it was hoped, a more federal governance structure would emerge. The main players in the negotiation, Germany and France, did not have the same views on what this structure would be, but they shared the same dream: both expected the euro to accelerate integration.

Reforms of limited ambition are still possible and desirable but on the whole the euro is bound to live with this governance structure in the years to come. This does not mean that it is doomed to fail. In fact it has thrived in its first ten years of existence. The euro has provided price stability to previously inflation-prone countries. It has offered a shelter against currency crises. It has by and large been conducive to budgetary discipline. It has attracted five new members in addition to the eleven initial ones. And many countries in Europe wish to adopt it.

On the world scene, the euro has also been successful. Even though research presented in this volume confirms that it

has not rivaled the dollar's world currency status, it has certainly become a strong regional currency in Europe and the Mediterranean region. Some countries in the region have *de facto* adopted it, several peg to it, and many have become at least partially 'euroised'².

The question we address in this paper is whether the governance structure of the euro area is a handicap to further gains in its international role and influence. Is the incomplete character of European integration bound to be perceived as a lingering weakness? Or is the rest of the world likely to accept, and adapt to, the *sui generis* character of the European currency?

This could have remained an abstract and unsolvable question. In fact, while governance had long been a topic for discussion among European scholars and policymakers, the rest of the world understandably paid limited attention to it. However, the advent of the crisis has put European governance to an unexpectedly severe test. While the euro was introduced in the midst of the 'great moderation' period and benefited from it in the first eight-and-a-half years of its existence, the following 12 months were more agitated and the last six months of its first decade were especially stormy. What this limited experience has shown is that there is a sharp contrast between what can be expected from a governance system in fair-weather conditions and in stormy-weather conditions. At the time of writing (early 2009), several lessons from this experience can be drawn already. Many more will certainly come.

To address this question, we start in section one by briefly laying out our conceptual framework. Section two is devoted to assessing the euro area's fair-weather record. Stormy-weather governance is reviewed in section three. We draw lessons for governance in section four and conclude in section five on the implications for the international role of the euro.

1. Accounts of the first ten years of the euro can be found in European Commission (2008) and Pisani-Ferry *et al* (2008).

2. See especially György Szapary's contribution to *The Next Global Currency?* (Pisani-Ferry and Posen, 2009).

1. Conceptual framework

Citizens generally do not expect their political leaders to exhibit the same qualities when the country is in peace and when it is at war. Similarly, one does not expect the same from economic governance in normal and in crisis times.

In normal times key properties are stability, predictability and incentive compatibility:

- After the damage of inflation and the stop-go policies of the 1970s, the vast majority of countries in the world have converged on policy regimes that give high priority to macroeconomic stability. Clarity of objectives and transparent matching between policy objectives and policy instruments, including by assigning price stability to an independent central bank, have proved to be key techniques in this respect.
- In a world of forward-looking expectations, the predictability of the policy course and of its responses to shocks has become regarded as an essential property. Policy rules that inform the public about the policymakers' reaction function have gained increasing support, either in the primitive form of instrument rules or in more sophisticated forms such as flexible inflation targeting.
- Finally, incentive properties are of major importance in a system like the European one that relies heavily on decentralisation. With monetary policy centralised but budgetary and structural policies decided upon at national level, it is important that actions taken at one level integrate with those taken at another level in a way that is consistent with the overall objective. Especially, a key issue is whether or not actions taken centrally create incentives for stability-oriented actions by decentralised players. For example, important questions are whether the system is able to make budgetary policies consistent with the overall goal of price stability and whether labour and product market reforms introduced at national level are conducive to swift adjustment in response to shocks.

However, different properties are needed in crisis times. Stability remains the objective in the medium term but, in the short term, speed in countering the effects of the crisis is rather the overriding goal. Instead of predictability, policymakers seek maximum discretion to address problems as they emerge and freedom to adopt innovative, previously untested solutions if needed. Finally, centralisation with a view to ensuring swift implementation takes precedence over incentives for good behaviour at decentralised level. Hence the qualities that are expected from a policy system in crisis times are clearly different from, and to some extent even

contradictory to, those expected from the same system in normal times.

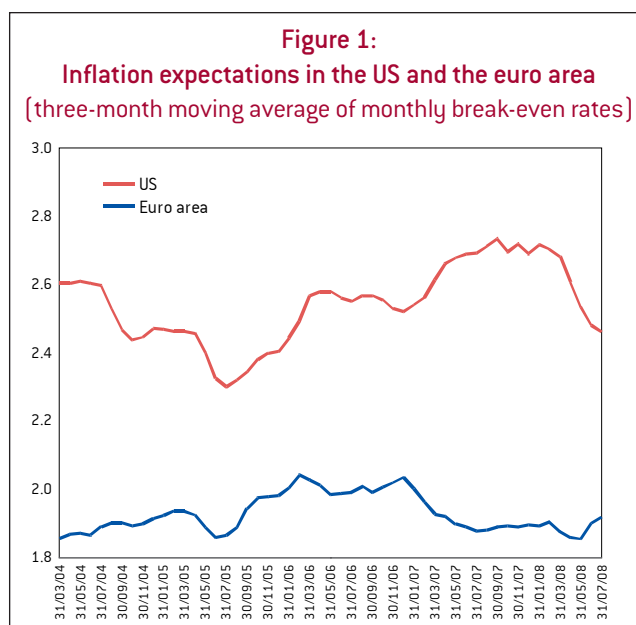
A telling illustration of this tension is provided by fiscal and monetary policy. In normal times the consensus view among economists is that the two instruments should be managed separately and that interaction between the two should be minimised. But in crisis times there can be a need for considerable interaction between monetary and budgetary policies.

Criteria for assessing the performance of the euro area therefore need to be specific to the situation. Instead of analysing performance in normal times and assuming that this record is indicative of the performance across the entire distribution of probable events, we draw a sharp distinction between the two types of situation and analyse performance accordingly.

2. The fair-weather record

The record of the euro area was extensively assessed on the occasion of the tenth anniversary of the common European currency (see especially European Commission, 2008 and Pisani-Ferry *et al*, 2008, on which this section draws).

It is widely agreed that the transition to the euro was remarkably smooth and that, in spite of the disparity of the participating countries' previous inflation records, price stability has on the whole been achieved. Figure 1, showing for the US and the euro area the break-even measure of inflation expectations, indicates that they have remained low and stable over the 2004-2008 period, including during the 2008 commodities-induced price hike. This has been a major contribution to macroeconomic stability.

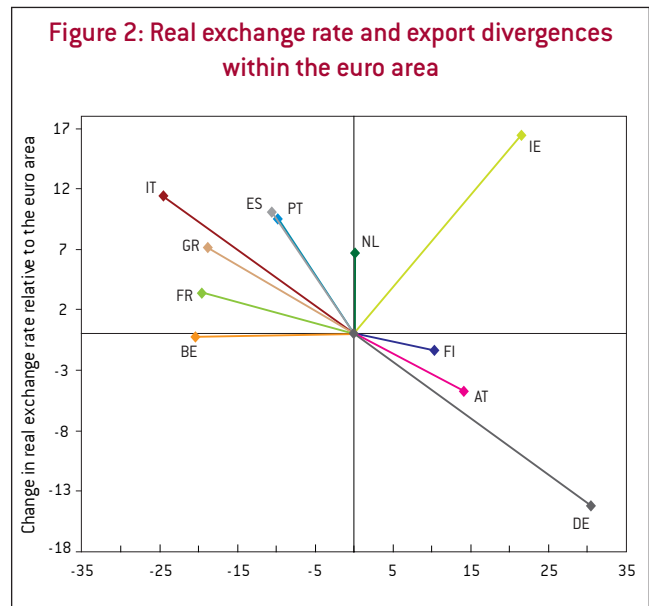


Source: BIS, Bruegel calculations

Though still positive, the record is less satisfactory for budgetary discipline. Overall, the euro area's aggregate budgetary deficit was brought down from 2.3 percent of GDP in 1998 (the last year before the euro) to 0.6 percent in 2007, and gross public debt as a percentage of GDP was reduced by five percentage points. This was a better performance than the US, where the deficit increased over the same period and where the debt ratio remained roughly constant. But there have been two shortcomings: first, in spite of the elaborate apparatus put in place to prevent and punish excessive deficits, one country (Greece) still had a deficit above three percent in 2007 and two (France and Portugal) were perilously close to the threshold. To say the least, this indicates the uneven effectiveness of the Stability Pact. Second, and more importantly, the budgetary framework overlooked the potential for quickly transforming private debt into public debt through bail-outs of insolvent private institutions and agents – and more generally through triggering sharp boom-and-bust cycles that can make the budgetary situation look artificially sound before it sharply deteriorates in a downturn. Ireland and Spain were considered paragons of fiscal virtue at end-2007, but the European Commission now forecasts their debt ratios to deteriorate by 20 and 30 percentage points respectively by end-2009³. This suggests that the focus on national account data, the absence of stress testing and the neglect of off-balance-sheet liabilities have been significant weaknesses of the European budgetary discipline framework.

'Euro-area governance has been a disappointment for external monetary and financial relations.'

European surveillance was even less effective in addressing non-budgetary sources of instability. Article 99 of the Treaty mandates the EU to monitor economic developments in member states and to ensure that they remain mutually consistent. In part because Article 99's provisions are markedly weaker than those regarding excessive budgetary deficits, and in part because of the misguided belief that there is little macroeconomic instability to fear when monetary policy is geared towards price stability and budgetary policy towards the avoidance of excessive deficits, little effort was devoted to macroeconomic surveillance. The assumption that by controlling budgetary deficits one is able to control instability risk was already questioned in the aforementioned 2008 Bruegel and Commission reports. In particular, it was noted that enduring price development divergences could be observed within the euro area, possibly resulting from real exchange rate misalignments (Figure 2). In other words the so-called 'competitiveness channel' was too slow and too weak to prevent boom-and-bust cycles fuelled by excessively low real interest rates (which themselves resulted from above-average inflation). As the boom



Source: Bruegel calculations on the basis of Eurostat and DG ECFIN data.

ended Spain and Ireland, the two champions of the euro's first decade, plunged into deep and probably long recessions.

With the benefit of hindsight the obsession with budgetary numerology and the failure of surveillance to trigger appropriate policy responses can be regarded as a major flaw in the policy system. Even in the absence of a global crisis, they would likely have resulted in significant adjustment difficulties. To undergo this adjustment in the context of a worldwide recession is a major challenge for the countries affected and the euro area as a whole.

In spite of the success of its currency, euro-area governance has finally been disappointing in the field of external monetary and financial relations.

The relationship with immediate neighbours and potential candidates for membership has been marred by controversies about euro-area entry criteria. While several countries in the region quickly adopted the euro as an external anchor and/or became largely euro-ised, the attitude of the euro-area authorities has been very guarded. The Commission, the ECB and the Eurogroup insisted on sticking to the letter of the entry criteria, defined at Maastricht and used in 1998 at the time of the creation of the euro area, even though benchmarking the inflation performance of a candidate country amounted to ignoring the existence of the euro area and the fact that the ECB had adopted a price stability definition. There was a failure to adopt a criterion that preserved the spirit of the treaty while being adaptable to changing

3. On the basis of EU Commission forecasts released in January 2009.

conditions, and this was widely interpreted as indicating a reluctance to pursue a comprehensive enlargement.

Relations with international partners developed positively as a growing number of countries in the world recognised the emergence of the euro as a major change in the international landscape, but it has been made unduly complex by the fragmented nature of the area's external representation. Table 1, from Pisani-Ferry et al. (2008), gives an overview the external representation of the euro area. Even in normal times, such a degree of fragmentation and unevenness is bound to be a source of ineffectiveness.

3. Stormy-weather experience

The weather in the euro area, which had been mostly fair since 1999, quickly became overcast and windy in the summer of 2007, when Europe suddenly faced a liquidity crisis detonated by tensions in the US sub-prime mortgage market. Remarkably, the ECB was the first central bank to react, with an injection of €95 billion (\$130 billion) on 9 August designed to ensure orderly conditions in the euro money market. Later the same day the Federal Reserve provided \$24 billion of liquidity. The next day, the ECB and the Fed intervened again to the tune of, respectively, €61 billion (\$84 billion) and \$38 billion, with other central banks around the world injecting a total of roughly \$20 billion.

During the next 13 months, the ECB continued to apply three measures to alleviate tensions in the euro money market.

First, it continued to frontload the supply of liquidity over the reserve maintenance periods. Second, the ECB maintained the increased share of longer term refinancing operations in its refinancing operations, which it had gradually built up since the start of the crisis. Third, the ECB continued to conduct US dollar term auction facilities in cooperation with the US Fed and other central banks, thereby providing US dollar liquidity to euro area banks. Altogether these measures proved that the European Central Bank was as capable as the US Federal Reserve to contain the liquidity crisis, thus reassuring the euro area that its policy framework was robust to stressful conditions.

Then, on 14 September 2008 another significantly more severe shock came from the US: Lehman Brothers had gone bankrupt. The same day, credit default swaps ratcheted up, stock markets plummeted, central banks injected billions of dollars into money markets, and Bank of America agreed to buy Merrill Lynch. The liquidity situation deteriorated further on both sides of the Atlantic and spreads between short-term interbank interest rates and swap rates on government securities reached unprecedented levels. Two days later, AIG Corp, the world's biggest insurer, was bailed out by the US Federal Reserve. The next day, the banking crisis spread to the United Kingdom: Halifax Bank of Scotland (HBOS) merged with Lloyds TSB in an emergency rescue plan. On 29 September the Belgo-Dutch bank Fortis was bailed out by Belgium, Luxembourg and the Netherlands, and the next day the Belgo-French bank Dexia was bailed out by Belgium, France and Luxembourg.

Table 1: Representation of the euro area in various global forums

	European Central Bank	Eurogroup Presidency	EU Presidency	European Commission	EU member states
OECD	<i>Participates in Economic and Development Review Committee, Economic Policy Committee and Committee on Financial Markets</i>	<i>Participates in Economic and Development Review Committee examination of the euro area</i>		<i>Quasi-membership (no voting rights and does not contribute to OECD budget but participates in all meetings)</i>	19
IMF Executive Board	<i>Observer status</i>		<i>Euro area position represented by Executive Director holding EU/euro area presidency</i>		27
Financial Stability Forum	<i>Full participation</i>				5
International Monetary and Financial Committee	<i>Observer status</i>		<i>Full participation depending on the constituency agreement</i>	<i>Observer status</i>	27
IMF Multilateral Consultations	<i>Full participation</i>	<i>Full participation</i>	<i>No</i>	<i>Full participation</i>	
G7 Finance Ministers	<i>Nearly full attendance</i>	<i>Nearly full attendance</i>		<i>Partial attendance (not involved in preparatory work)</i>	4
G20	<i>Full participation</i>		<i>Full participation</i>	<i>Attends meetings as part of the EU Presidency delegation</i>	5

The rapid rescue of Fortis and Dexia was hailed as a success and led to the belief that the previously untested capacity of euro-area governments to cooperate in times of crisis was real. However, the mood changed rapidly. On 30 September, the Irish government unilaterally guaranteed the safety of all deposits, bonds and debts in Irish banks for the next two years. On 3 October, the Dutch government nationalised the Dutch activities of Fortis, forcing the Belgian government to take over its Belgian activities. Rather than continuing to cooperate and splitting the bill to maintain the Belgo-Dutch bank, the two governments simply decided to split the bank along national lines. On 4 October, a meeting of the heads of state of the four major euro-area countries ended in empty words as Germany refused to agree on a concerted bank rescue and stabilisation plan. Finally, on 5 October, the German government issued a unilateral guarantee of all deposits in German banks. The weather in the euro area had now definitely turned dark and stormy.

For a while, it looked as if the EU, or even the euro area, was unable to coordinate the response to the crisis. A group of prominent economists rightly worried that: 'The current approach of rescuing one institution after another with national funds will lead to a Balkanisation of the European banking sector. Agreeing a harmonised level for deposit insurance would also be important' [Alesina *et al*, 2008].

At the Eurogroup and ECOFIN meetings on 6-7 October, finance ministers agreed that the economic situation 'calls for a coordinated response at the EU level', but failed to adopt anything beyond broad principles and did not even discuss the rescue plan that the UK government would announce on the following day. On 8 October, the ECB reduced its policy rate by fifty basis points and changed its tender procedure, moving to fixed-rate refinancing. However, this step failed to impress money markets. At the end of the week, financial markets throughout the world suffered one of their worst days in history ("Black Friday"), which prompted the French presidency of the EU to convene the first-ever meeting of the heads of state and government of the euro area. This emergency summit, held in Paris on 12 October, is viewed as the turning point in the efforts to bring about a concerted European response to the financial crisis.

The Paris summit was a success on many fronts. First, it sent an important message to the markets. European governments abandoned the uncoordinated case-by-case approach that had prevailed in favour of a series of national plans based on a common template and pledged a total of nearly €2 trillion to shore up their financial sectors, sparking sharp rallies across the continent's stock markets.

Second, the summit demonstrated that the euro area is not only governed by the ECB but also by political leaders. The message could not have been sent by the Eurogroup for two reasons. First, finance ministers lack the public recognition that heads of state and government enjoy. Moreover, despite being his country's prime minister, Jean-Claude Juncker, the president of the Eurogroup, clearly lacks the kind of European public recognition that President Sarkozy enjoys. Second, because the Eurogroup meets routinely and in the drab building of the EU Council, it could not have conveyed the sense of emergency and importance that was attached to the first meeting of euro area leaders held in the Elysée Palace.

Third, by inviting Prime Minister Gordon Brown to the Paris meeting, President Sarkozy succeeded in building a bridge between the euro area and not only the most important EU country outside the euro area, which was significant politically, but also with the area's main financial centre, which is equally important. Indeed, the financial crisis has exposed a fundamental issue of economic governance of the euro area. While members of the euro area clearly share common financial interests owing to the fact that they share a common central bank, they also have common financial interests with the other members of the EU, and the UK in particular, by virtue of the single market for financial services. This fundamental issue also has implications for the UK, since any remedy to the euro area's financial governance that did not include the UK – for instance a euro-area banking supervision mechanism – would risk jeopardising the role of London as the euro area's *de facto* financial centre.

Lastly, the show of unity among all EU leaders at the European Council meeting that was held a few days after the Paris summit enabled the European Union to assume a role of global leadership in the crisis at two levels. First, the United States adjusted its banking rescue plan to make room for capital injections, thereby bringing it closer to the European template, itself based on the UK plan. Second, and more crucially, immediately after the European Council meeting, President Sarkozy and Commission President Barroso flew to Washington to meet with President Bush, carrying with them the proposal, originally put forward by Gordon Brown and adopted by the European Council, for a global summit to be held before the end of 2008 to reform the world financial system. The European proposal laid the foundation for the series of G20 leaders' summits on financial markets and the global economy, the first held in Washington on 20 November, 2008, and the second in London on 2 April, 2009.

Despite the undeniable success of the Paris summit and the decisions taken at the ensuing European Council meeting, many problems have lingered. Not only did a number of

'Despite the Paris Summit's success, many problems have lingered.'

important policy issues remain unsolved, but an economic crisis soon came on top of the financial one, bringing new challenges to euro-area governance.

Several major policy issues still remain unsettled. The first concerns the treatment of pan-European banks. After Fortis and Dexia (whose bail-out by national governments was only a first step and whose fate has not been settled at the time of writing), a number of other banks with pan-European operations needed to be rescued. Fortunately, however, none of these institutions are quite as multinational in their governance structure as Fortis was and Dexia remains. Their bailouts were therefore purely national. Had a bank required bailing out by several states (or if it were to require it in the near-future), the lack of burden-sharing rules among European countries would inevitably have created a problem.

The second issue concerns the situation of small countries with relatively large financial institutions. Clearly small countries have suffered more than large countries. The bailouts in France and Germany account for less than two percent of each country's GDP and, even in the UK, they barely attain three percent. By contrast the bailouts represent around four percent percent of GDP for Ireland and Belgium and six percent for the Netherlands and Luxembourg. Austria, a small country whose banks are heavily exposed in central and eastern Europe, has already committed some five percent of GDP. Judging from spreads and credit default swaps on government bonds, markets are already pricing the risk that public finances in small countries like Austria or Ireland could pay a high price for rescuing their banking sectors. With no common EU or euro-area coffer, some small countries may have to rethink their financial sector strategies and even question the very principle of specialising in the provision of financial services.

The third issue is the situation in central and eastern Europe. Until 15 September the countries in the region were hardly affected by the crisis. There were difficulties in some countries but they were mostly national in character. However, after the bankruptcy of Lehman all changed: interbank markets have been strained, there have been capital flow reversals, several currencies have depreciated sharply, and the recession has suddenly hit the region. Against this background, the euro area's response has been slow. It first overlooked the potential consequences of its decisions on neighbouring countries – be they capital outflows in response to the issuance of better guarantees in the western part of Europe or credit curtailments in response to demands made to banks to extend credit further in their home country. The euro area was then reluctant to formulate an overall policy response, beyond the financial assistance provided to

countries under IMF programme. There was a fear of assuming some form of responsibility for what were perceived as national policy issues. These hesitations have tended to overshadow the participation of the EU in IMF financial assistance programmes in Hungary and Latvia.

The fourth issue is the fragmentation of the single market. Despite the common framework put in place to facilitate the funding of banks, to provide financial institutions with additional capital resources and to allow the recapitalisation of distressed banks, it appears that uneven implementation of commonly agreed rules is the norm rather than the exception. Not a day goes by without a measure being taken by an EU country that either seems to favour national financial institutions and/or requires these institutions to provide credit to national customers.

'Several major policy issues still remain unsettled.'

The fifth and final issue concerns the design and implementation of a fiscal stimulus. While governments were trying to respond to the banking crisis, it became clear that it would soon unleash an economic crisis that would risk further aggravating the financial situation and create a downward spiral resulting in economic depression. In order to avoid this eventuality, several voices on both sides of the Atlantic came out in favour of a stimulus package. On both sides, there were natural concerns about fiscal sustainability.

Even among the vast majority who supported the idea of a fiscal stimulus, two additional issues were raised in Europe, both relating to the absence of a euro area (or EU) federal state. The first is the lack of a euro area fiscal instrument to support economic activity, and the need to rely on national instruments without being able to rely on an effective coordination mechanism. The second is the fact that euro-area members entered the crisis in very different fiscal shape, rendering the decision to adopt national fiscal instruments all the more difficult. The *European Recovery Programme* put forward by Pisani-Ferry, Sapir and von Weizsäcker in mid-November 2008 was precisely designed to counter these two issues. It envisaged a harmonised indirect tax (VAT) cut in all EU countries, and the creation of a mechanism to ensure medium-term fiscal sustainability in countries with unfavourable starting conditions.

The European Economic Recovery Plan proposed by the European Commission a couple of weeks later also recognised the difficulty of engineering a European fiscal stimulus without proper European instruments and with diverse national situations, but fell short of proposing the use of common mechanisms. Instead, it simply called on EU member states to adopt national measures. The Commission proposal was

adopted by the December 2008 European Council and has been implemented in various ways by EU members states. However, by essentially ignoring the two issues flagged above, the implementation of the European plan suffers from two problems.

First, because countries have been allowed wide discretion in the choice of fiscal instrument, many have adopted measures that tend to favour national producers at the expense of foreign producers, thereby reintroducing barriers in the single market.

Second, because no new mechanism to ensure the sustainability of public finances was introduced, a number of euro area countries soon began suffering great difficulties. For many years, markets seemed not to pay attention to differences in public finance conditions across euro-area countries. For instance, up to June 2007, the 10-year government spread over German bonds was as low as 20 basis points for Greece, despite a public debt of around 100 percent of GDP and persistent deficits. One year later, in spite of the liquidity crisis, its spread was still reasonably low at 60 basis points.

Since then, the crisis has left a heavy mark. Greek bond spreads jumped to 150 basis points in October 2008 and reached 250 points in early January 2009. Other euro area countries whose spreads have dramatically increased since October 2008 and were above 100 basis points at the beginning of 2009 are Ireland (212 points), Italy (128 points), Slovenia (126 points), Portugal (123 points) and Spain (109 points). As a result, several of these countries have already seen their S&P ratings downgraded by one notch. In January 2009, Spain's went down from AAA to AA+, Portugal from AA- to A+, and Greece's from A to A-, the lowest of any euro area country. This situation is worrisome because the euro area has neither a common funding scheme nor does it have a well-specified mechanism to assist members facing a potential national funding problem.

4. Lessons

In their report on the euro's first years, written and published before the crisis developed, Pisani-Ferry *et al* (2008) warned that: 'A policy framework should not only be judged by its

agility in fair-weather conditions, but also by its resilience in storm conditions – not only financial, but also economic and political storms. In this respect, it should be recalled that the last eight years have been benign. The policy framework of the euro area has thus not yet been tested under stress. It remains to be seen how well EMU is set up to deal with events like disruptive global shocks or internal crises.'⁴

The experience since the start of the crisis confirms that the euro area governance system was well equipped to deal with normal conditions, even though there is need for improvement in the scope, priorities and methods of surveillance, but lacks the properties required to operate in crisis times as enumerated in the first section, namely speed of reaction, policy discretion and centralised action. At the centre of the problem is the absence of a euro-area political body capable of taking appropriate financial and fiscal decisions in difficult times. Ad-hoc coordination has indeed substituted institutional responses and this has been welcome. There are, however, limits to what this type of coordination can achieve.

The Eurogroup could, one day, evolve into such political body, but it is far from there at the moment. For the time being the Eurogroup is simply an informal body without a defined mission, whose role had developed in two directions prior to the crisis: as an enforcer of EMU rules and as the venue for addressing the collective action problems faced by euro area members. Although it was always better at the first task (because it could rely on treaty-based mechanisms for implementation), the latter task has simply been ignored since the beginning of the crisis, despite the fact that it is precisely the role that it should have assumed⁵. Were it not for the October 2008 euro-area summit in Paris, the governance of the euro area during the crisis would have been assumed by the ECB alone, thereby underscoring the fact that the euro is not only a currency without a state but even without political governance.

The governance of the euro area has been, since the launch of the euro, the subject of difficult discussions between its members, especially between France and Germany. Whether or not the lessons from the crisis will be drawn by these countries will largely depend on their ability to agree on a diagnosis of the problem and on remedies.

4. See Pisani-Ferry *et al* (2008), p. 8.

5. The move in 2005 to a fixed presidency of the Eurogroup, instead of a rotating one, was intended to give it the means to take initiative and exercise leadership, but initiatives and leadership have been remarkably absent.

5. Conclusions

What are the implications of our analysis of euro-area governance for the international role of the euro, both as a regional and a global currency?

As already indicated, the euro had become a successful international currency during the relatively calm years that preceded the crisis. Even though it had not rivalled the dollar's world currency status, it had certainly become a strong regional currency and it has been adopted as an anchor, as a reference or as a vehicle for financial transactions in the countries bordering the euro area.

Is there reason to believe that the management of crisis so far will dramatically alter this state of affair?

Our feeling is that the governance of the euro area in the current stormy-weather conditions has not enhanced the international status of the euro.

Within the euro area, rising bond spreads and falling ratings in some members, and the absence of a common funding scheme and of a well-specified mechanism to assist those facing funding problems, have done nothing to improve the image of the euro with global investors. Although we regard

recent remarks on the possible exit or expulsion of those members from the euro area as pure fantasy, we acknowledge that the lack of clarity on how to resolve their debt problems is a source of worry.

In the region, the treatment by the euro area of regional partners which are currently facing severe economic and financial difficulties and rely on the euro as their reference currency has not been satisfactory either. Such partners include primarily new EU member states, but also countries outside the EU, like Ukraine. These countries have typically suffered from the drying up of capital flows from the euro area and from the lack of assistance by euro area institutions, including the ECB⁶. Although this divide between countries inside and outside the euro area may accelerate the adoption of the euro by some outsiders, the vast majority is unlikely to join before the end of the crisis. In the meantime, therefore, the weak crisis governance of the euro area is likely to be a burden on these countries, which may affect their choice of reference currency.

In conclusion, the euro has proved to be attractive as a fair-weather currency for countries and investors well beyond its borders. But it still remains to be seen whether it is equipped with a strong enough governance also to succeed as a stormy-weather currency.

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6. See Darvas and Pisani-Ferry (2008)..