GLOBAL AND REGIONAL SURVEILLANCE:

LESSONS FROM THE EURO-AREA CRISIS

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In mid-2010, Michel Camdessus , Tommaso Padoa-Schioppa and Alexandre Lamfalussy took the initiative to invite a group of fifteen friends, former ministers, central bank governors and heads of international Institutions, to join them and engage in in-depth discussions of the problems confronting the international monetary system and of possible reforms aimed at addressing them, in the light of the global financial crisis which erupted three years before. Indeed, they had in mind, like the other members of the group, that in addition to evident shortcomings in prudential supervision and financial regulation, the failings of the international monetary system contributed notably to the global liquidity crisis that triggered the financial crisis. They also thought that the crisis had provided a unique opportunity to identify solutions to a series of problems that the international community had not managed to resolve since the Bretton Woods system was abandoned in the early 1970s.

The discussions took place during the fall of 2010 and the first weeks of 2011. Three meetings were held[1], the third one in Paris, in the Palais Royal premises of the Banque de France, from which comes the name of “Palais Royal Initiative”. The word “initiative” expressed the fact that this exercise was fully private, without any official mandate, even though its results were aimed at policy-makers.

The report was unanimously approved by the Group[2] on 8 February 2011. It included eighteen specific suggestions in the areas of financial and economic policies, exchange rates, global liquidity, the role of SDRs, and governance. Indeed, matters related to surveillance were actively discussed and made up a significant part in the document. President Nicolas Sarkozy, at the helm of the G 20 during the year 2011, agreed upon reception of the report to circulate it to his colleagues in view of discussions which were supposed to be concluded during the Cannes Summit scheduled for November 3rd. In the meantime, the report was discussed at the technical level, and among Ministers and Governors during a special seminar on the international monetary system which took place in Nanking on March 31st. Later on, however, since the Cannes meeting and the subsequent ones were overburdened with euro-area crisis topics the reform of the international monetary system could not

[1] Tommaso Padoa-Schioppa passed away a few weeks before the third meeting

[2] Members of the Group, from fifteen different countries : Sergey Aleksashenko, Hamad Al Sayari, Jack Boorman, Michel Camdessus, Andrew Crockett, Guillermo de la Dehesa, Arminio Fraga, Toyoo Gyohten, Xiolan Hu, André Icard, Horts Koehler, Alexandre Lamfalussy, Guillermo Ortiz, Tommaso Padoa-Schioppa, Maria Ramos, Venugopal Reddy, Edwin Truman, Paul Volcker.

really be discussed by the Heads of State and Governments. So far, due to a lack of political impulse, the G20 has only agreed on a relatively modest set of proposals, far from the meaningful reform of the system which was called for by the Group[3] and is still badly needed.

On the specific issue of surveillance, the report recommends to address the fiscal, monetary and financial policies of national governments, with particular attention to exchange rates and to global liquidity developments. A comprehensive set of norms or quantitative benchmarks on economic and financial policies and performance are envisaged to “function as alarm signals with appropriate thresholds”. In particular, it is recommended that firm surveillance be extended to all economic and financial policies relevant for both domestic and global macro-financial stability. For this purpose, some articles of the IMF Articles of agreement should be amended. A persistent breach of norms would trigger a consultation procedure and, if needed, remedial action. A system of both sanctions and positive incentives is considered to strengthen the surveillance. The report notes also the persistent failure of the peer pressure approach[4] and recommends that all the norms apply first to big systemic countries and not only to the small ones, as it has been too often the case so far.

This paper aims at revisiting these topics on multilateral surveillance, taking into account the lessons to be drawn from the euro-area crisis which took place after the report[5] was approved.

I/ SURVEILLANCE FAILURES BEFORE AND DURING THE EURO-AREA CRISIS

According to European treaties, if a member country persistently violates its obligations, sanctions can be imposed. In this respect the set of rules appears more binding in Europe than at the global level, according to the current IMF rules. By considering a system of both sanctions and incentives, the Palais Royal initiative report proposes moving in this direction. In reality, serious breaches in the conduct of economic and fiscal policy in European countries have not been sanctioned and poor results were achieved in the domain of surveillance within the euro area: rules were frequently breached, the public debt rule proved to be not fully adequate and vigilance was weak, as the system of surveillance left some important domains aside.

[3] Michel Camdessus “The Palais Royal Initiative and its aftermath” in “In search of a new World Monetary order” International Triffin Foundation. Proceedings of a conference to celebrate the 100 th anniversary of Robert Triffin.
[4] In this respect, the reports mentions “…The tendency for the present peer review processes to operate as peer protection, suggesting the need for a mechanism to break the de facto non-aggression pact among major countries that leaves the global interest without an effective advocate” (Boorman et Icard P. 23- see footnote N° 5))
[5] The report and the material which contributed to the deliberations of the Group at different stages of the initiative, such as background papers and responses to specific questions posed by the Group to experts on the international monetary system, were reproduced in a book “Reform of the International Monetary System- The Palais Royal Initiative” edited by Jack T. Boorman and Andre Icard. SAGE Publications Sept.2011

1°The rules were frequently breached

The rules were frequently breached, starting with the Union's main countries. For example, in 2003, Germany and France agreed to suspend the "Stability and Growth Pact", in view of its reform, thus allowing fiscal imbalances well in excess to the Maastricht treaty rule without having to bear the risk of a reinforced surveillance procedure. In July 2004, the European Court of Justice invalidated this suspension but confirmed that it was up to the Council to decide upon sanctions. The door was left open to a kind of "peer review" practice.

In the same vein, In 2007, the newly elected French government decided unilaterally, without any significant reaction from the other members or the Commission, not to implement the fiscal adjustment program that the previous government had agreed upon, after intensive negotiations.

In the case of Greece, is it necessary to recall the serious statistics manipulations carried out by this country in view of massaging the convergence criteria conditioning access to the euro? Once again, there was no significant reaction and it is highly regrettable that, later on, disastrous trends in terms of budget and public debt were again largely hidden until the newly elected Papandreou government unveiled them, when taking in charge of public affairs.

Currently, among the 17 members of the euro area, only 5 (Estonia, Luxembourg, Finland, Slovenia and Slovakia) have a public debt/GDP ratio below the 60% threshold, and, in 2013, only 4 (Finland, Italy, Germany, Estonia) are likely to be compliant with the new 0,5 % structural deficit rule established by the 2012 Fiscal Stability treaty. Certainly, this poor situation has its roots in the economic and financial crisis and a good proportion of members are in line with their adjustment program, but this cannot erase the effects of an excessively long period of complacency.

In spite of the apparently strong set of measures included in the Maastricht treaty aimed at ensuring a fair degree of good economic and fiscal behavior in the member countries, and despite the political structure in place, which was supposed to ensure an appropriate implementation of the rules agreed in common, the functioning of the euro area has been disappointing in terms of surveillance and discipline. With the rules being forgotten by quasi consensus, the system worked basically on the basis of "peer surveillance", with no better result than the one depicted at the global level in the Palais Royal initiative report. The failure to impose tough budget constraints on governments allowed them to postpone their efforts to address fiscal imbalances, leaving them without adequate budgetary flexibility to cushion the crisis. However, the successive attempts to overcome the crisis have progressively pushed European governments down the road of increased economic and fiscal integration, one could say of more federalism. In the budgetary domain, the new fiscal treaty imposes binding rules, imbedded in each country's constitution or fundamental laws, to ensure budget equilibrium, which will be subject to a strict *ex-ante* and *ex- post* surveillance, at the European level. While it is too early to judge the effectiveness of this new set of measures, there is no doubt that it represents a good step in the right direction.

2°Inadequacy of the public debt rule

The crisis which hit the euro area in 2009-2010, in addition to bringing to light the inability of the "Stability and Growth Pact" to impose discipline in weak countries, revealed also an excessive focus on fiscal matters, to the expense of other important macroeconomic imbalances, such as private debt, external deficits and cumulative losses of competitiveness. These two last gaps will be discussed in § 3, to focus on the absence of any benchmark on private debt amounts to criticism of the adequacy of the Pact's public debt rule. In fact, Spain and Ireland, both countries hardly hit by the crisis and now showing a public debt significantly exceeding the Pact's ceiling, were fully compliant with this rule before 2007, but had accumulated a huge amount of private debt which, later on, had to be taken over by the public sector. The same situation occurred in the United Kingdom.

As the economic situation was worsening after 2007, the private sector debt which had been previously accumulated became less and less credible, contaminating bank's balance sheets and placing a heavy burden on governments, keen to avoid runs and bankruptcies in their national banking sector[6] . When the financial bubble burst, the risk on private debt increased, spreading first to banking risks, then to sovereign risks because of the government's guarantor role, and translating finally into higher sovereign debt. This porosity between private and public debt casts a serious doubt on the accuracy of a rule solely focused on sovereign indebtedness.

While the value of fiscal deficit and public debt norms or ceiling cannot be denied, the lessons which can be drawn from the euro area crisis shows the necessity to complete this framework with a similar surveillance of the evolution and the stock of private debt. This could take the form of monitoring an additional set of aggregates in parallel or, alternatively, taking as reference broader aggregates including both private and public debt, such as "total debt", which are present in the data bases published by many central banks. Such an enlargement of the debt coverage would enrich surveillance, making it more accurate, would provide a more pertinent image of countries which run a big public debt along with a significant private saving ratio, and *vice-versa*, would offer to markets more tools to better evaluate risks on sovereign debt portfolios. Unfortunately, among the different reforms envisaged or decided in the euro area, this relatively simple proposal has not been considered so far.

[6] Chiara Angeloni and Silvia Merler,(Bruegel Dec. 2012)

3° Surveillance gaps.

Two domains that proved to be key in the triggering and the development of the euro area crisis remained outside the scope of surveillance: assessing weaknesses in the financial system and taking account of countries' external factors.

In spite of late efforts to harmonize and strengthen supervisory structures at the European level, in accordance with the de Larosière report**, bank supervision** was still largely fragmented when the crisis erupted. The quality of supervision was uneven; coordination between national authorities was insufficient; in spite of the harmonization achieved, regulations were not implemented with the same degree of strength from a country to another; and in some countries, financial structures were not as solid as they should have been. All this meant that weaknesses in national financial systems were not always correctly assessed and that the support of governments to avoid systemic failures was often necessary, triggering the transfer of debts from the private to the public sector, as described in §2.

After a long period of hesitation and several both partial and insufficient attempts to address this systemic weakness in the monetary union design, European leaders embarked on a banking union which will transfer responsibility for bank supervision, and ultimately resolution and capitalization to the European level. This was indeed a significant policy change which helped considerably to change market sentiment.

As the IMF had already perceived during previous financial crises, monitoring the financial sector and a country's supervisory capabilities is a big component of crisis prevention, in addition to the more traditional macroeconomic surveillance. The development of FSAP procedures marks an evolution in this area. The Palais Royal initiative also stressed the importance of surveillance in this domain[7].

A second gap which proved to be especially damaging for the prevention and the management of the crisis at its early stage was the failure to focus on the imbalances accumulating progressively in **member countries' balance of payments.** The Maastricht treaty was influenced by the strong belief that in a monetary union, member countries' balance of payments was no longer relevant. Even those who, rightly, considered that the euro area was not an optimal monetary and currency zone thought that in a unified monetary zone, countries tend to converge and that a progressive unification of the financial system would ensure the intraregional capital flows needed to rebalance distortions appearing between member countries' current account. The United States, which is not immune from regional divergences[8] offers a model of this kind. As a matter of fact, if convergence criteria were set up to judge the ability of a country to join the Monetary Union, nothing similar was considered once this step was accomplished.

[7] Boorman and Icard p. 15

[8] Are the Euro-Area Countries an Optimal Monetary and Currency Zone?- A comparison with US Federal Reserve districts (Robert Sockin, Nathan Sheet.)

It is also interesting to notice that the "no bail out clause" so frequently put forward during the crisis was not much discussed during the preparation of the treaty, probably because it was not considered at the time to be controversial.

In fact, rather than converging, euro area countries have diverged as, after the exchange risk disappeared, they specialized in domains different from each other[9]. Within the euro area, economic and production structures became more heterogeneous while, as seen before, the financial sector remained fully segmented, country by country. In some economies, current account deficits progressively expanded, showing a growing saving gap offset by public and/or banking external debts, subscribed by investors at abnormally low interest rates. When those creditors became conscious that the level of debt had become excessive and that the Maastricht treaty's "no bail out clause" would play to limit if not prevent support from more robust countries, capital flows suddenly stopped and interest rates substantially jumped up.

Until the crisis erupted, the accumulation of external imbalances and divergences in competitiveness trends remained practically unnoticed. However it should be recalled that the ECB and, on a personal basis its President, Jean Claude Trichet, warned frequently about the divergences in labor cost trends. Similarly, the accumulation of balances in Target 2, which was in fact the counterpart in external monetary positions of "above the line" disequilibria in a situation where the interbank market was not working properly was discussed more in terms of the risks it generated for creditor central banks[10] or in terms of currency exposure[11] than for its meaning in terms of balance of payments. It is only recently that a more comprehensive approach to the problem was explored[12]

II/ WHICH LESSONS ?

From this double review of the proposals made by the Palais Royal initiative and the practice of surveillance in the euro area , three main issues emerge: the coordination between regional and global surveillance, the need to improve the quality of surveillance and political questions

1° Combining regional and global surveillance

[9] Patrick Artus et Isabelle Gravet « La crise de l'Euro » Armand Colin Oct. 2012

[10] Hans Werner Sinn "Target losses in case of a Euro breakup" CESifo Forum Volume 13-4 Winter 2012 /Michiel Bijsma and Jasper Lukkenen "Should we worry about target 2 imbalances?" Bruegel Sept. 2012

11Stephen Cecchetti and alii "Interpreting Target 2 Balances. BIS Working papers N° 393 December 20122

12 Philippine Cour-Thimann "Target balances and the crisis in the Euro area" CESifo Forum Special issue April 2013

As the Greek crisis was developing, European authorities first expressed reservations about any involvement of the IMF in the resolution process. This policy had its root in the idea that the crisis was internal to the Euro area and thus had to be resolved exclusively among the members of this zone. It was only in 2010, when it became clear that problems were indeed too serious to be managed without external technical and financial assistance that IMF support was asked for. It was a kind of recognition that the crisis was global and, as such, needed, at least in part, a global solution.

In terms of surveillance, euro area countries are subject to a double surveillance by the IMF and within the European framework. The former has big shortcomings, as shown in the Palais Royal Initiative report, and the latter is weak, as we saw before. Furthermore, the two procedures, while aiming at similar goals could not be interconnected nor harmonized. It would have been much better to have only one process of surveillance, but an effective one. The lesson drawn from the crisis is that regional surveillance is not a substitute to the global one, unless a significant degree of federalism and constraint is in place. When the two act in parallel, coordination should be established, with preferably an appropriate burden sharing. For example, due to the degree of integration of the Union, significantly strengthened in 2012, one could imagine a coordination in which, on the basis of a comprehensive set of norms or benchmarks decided in common with the IMF, the European authorities would exert surveillance, with the possibility of sanctions, on individual countries members of the Euro Area while the IMF would include the entire euro area in its own surveillance procedure. Of course, such an arrangement would be greatly facilitated if euro area countries decided to pool together their IMF voting rights.

2° Improving the quality of surveillance

The Palais Royal initiative pointed the weakness of the current IMF bilateral procedures and asked for a revision of Articles IV and VI of the Articles of Agreement with view to giving the IMF the capacity to define a comprehensive set of "Norms" that would cover all relevant macroeconomic and financial domains. Suggestion N° 2 [13] proposes for this purpose current accounts, effective exchange rates, measures of capital inflows and outflows, reserve assets, inflation rates, fiscal deficits and debt ratios. Norms are also proposed to cover financial sector soundness and the quality of banking supervision.

[13] Boorman and Icard p. 15

The IMF experience, as well as the European one shows that surveillance should be comprehensive and cover all macro-economic and financial aspects. If not, there are risks that important and dangerous trends remain unnoticed too long.

The set of norms or quantitative benchmarks and their thresholds should also be revised periodically to remain fitted to the realities of changing economic structures and trends. Is not it surprising, for example that the fiscal deficit limit of 3% in term of GDP set up in the Stability and Growth Pact, defined at a time when the average economic growth in Europe was of a similar magnitude, have been maintained unchanged for more than 20 years, in spite of slowing economic trends in Europe during the same period?

However, periodically adjusting norms and thresholds requests a governance structure able to conduct these changes without political interference. Such a structure does not exist in Europe, as the main binding norms are matters for Treaties and it cannot be envisaged in the IMF without significant reforms. Political will is lacking to envisage such an evolution in a near future.

To be effective, surveillance should preferably include a consultation procedure periodically and on an ad hoc basis when a breach of norms is observed. According to the result of this consultation, sanctions and possibly positive incentives may follow. The purpose of the consultation would be to assess risks and possible adverse trends and, in the case of the breach of a norm to ascertain the underlying causes and potential consequences of the deviation. It should be noted that the recent European fiscal stability treaty diverges significantly from this approach as if the annual budget for any ratifying state is found not to comply with the deficit criteria, a more automatic procedure will start: The country will have to correct the situation following the "common principles" published by the European Commission in June 2012 .

Transparency is another important element of surveillance effectiveness as it contributes to the accountability of those engaged in this process. Statistics on norms should be easily accessible, breaches and, if it is the case, sanctions should be made public, and records and proceedings of consultation or adjustment procedures should promptly be released to the public.

Finally, bilateral surveillance cannot be fully effective if global imbalances are not addressed in parallel. The Palais Royal initiative insisted on the need to better understand and measure global liquidity. In the run up to the 2007 crisis an unsustainable global expansion was facilitated by rapid growth in global credit. The result was a global asset price boom. Then the crisis occurred and liquidity in financial markets all but evaporated. "Such extreme fluctuations have critical effects on the functioning of the global economic and financial system and macro-financial stability at the country level"[14].The world needs a politically acceptable process for prevention of unsustainable global imbalances.

[14] Boorman and Icard p. 18

Unfortunately, in this field, as in many other international matters at the European or at the global level, improvements are hard to achieve preventively in the absence of crisis[15].

3°Political questions

Surveillance cannot achieve its goal in the absence of an international political consensus. Unfortunately the latter is never perceived necessary in period of growth and financial stability. As the euro area crisis has demonstrated once again, Europe and the international community at large did not have a suitable agreed –upon mechanism to detect the rise of imbalances sufficiently in advance and to implement a prompt and orderly resolution of sovereign debt issues once the situation became unsustainable.

In Europe, significant progress was achieved progressively in 2011 and 2012, under the pressure of events and from markets, in the domain of both budgetary discipline and crisis resolution. But the former, focused mainly on fiscal balance and public debt adjustment, fell short of achieving an appropriate level of effective macroeconomic surveillance and the latter is still subject to political debate about real implementation.

In the case of the IMF, the institutional framework is inappropriate to pretend to offer a good solution to the weakness of international surveillance. The emergence of the G 20 as the de facto primary forum for economic and financial cooperation contributes to filling the gap left open by the G7-G8 in terms of involvement of the emerging word, but it has no binding power and it cannot speak for all countries in the global economy. Only the IMF can claim the role of central institution of the international monetary system. As a result, there currently exists an unfortunate gap between, on the one hand, an incomplete cooperation Group, the G20, which is the main forum for the Heads of State or Government of the largest nations and, on the other hand, the IMF, the global institution theoretically vested with operational powers. Ministers and Governors meet alternatively at the G 20 level and in the IMFC sometimes on the same topics, sometimes on different agendas. This poor governance framework is a major source of inefficiency in the conduct of global financial affairs and contributes to the weakness of surveillance procedures.

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[15] Anne O. Krueger « Sustainability and reform of the International Monetary System » in "In search of a new world monetary order" proceedings of a conference to celebrate the 100th anniversary of Robert Triffin PIE Peter Lang 2012

The Palais Royal initiative made significant proposals in view of the solution of this problem, considering a new organization within a single "decision making structure combining legitimacy and effectiveness by giving a formal framework to the relationship between the pertinent group of Heads of State or Government, the Group of Ministers and Governors and the key International Financial Institutions" [16]. Up to now, this proposal is still a vain wish.

Large and powerful nations are permanently reluctant to be told what to do in terms of their macroeconomic policies and financial structures and international institutions are too weak to overcome this difficulty. Without a great deal of political will, surveillance and crisis prevention have little chance to become more effective.

In conclusion, recent significant policy changes have occurred in Europe and contributed to a change in market sentiment. The European fiscal treaty, the institution of significant crisis resolution financial tools, the banking union and the outright monetary transactions scheme launched in September 2012 by the ECB are significant steps forward and make it possible to envisage the future with more comfort. However, all doubts have not been resolved as the economic and social situation in southern Europe is still preoccupying and as there is no real consensus in Europe on future decisions to be made to make the monetary union more robust and prosperous. Europe lacks political unity and dynamism and any time the pressure abates, policy reforms tend to slow down if not disappear[17].

The lack of political will is also evident at the global level. During the two past years, attention mainly focused on the euro area crisis and very little was done to improve the international financial system in general and the international surveillance in particular. For example, the imperfections of the IMF have not been addressed by the G 20, *systemic boards* have mushroomed all around the word without much coordination and in the domain of understanding and monitoring global liquidity, if useful progress has been recently achieved by the BIS[18], work is still in a phase of research.

While the situation of the global economy is still weak and monetary policies extremely accommodative, more and more countries look at exchange rate policies as a mean to make their economies more dynamic, and more and more comments are made considering inflation as a suitable solution to current problems. In such an environment, global financial stability looks fragile; no doubt that in current conditions of sluggish global economy a new phase of financial turmoil would be very damaging.

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[16] Boorman and Icard , P.23

[17] Jean Pisani-Ferry « Is the Euro crisis over ? » Bruegel Feb; 2013

[18] "Understanding Global Liquidity" Sandra Eickmeier, Leonardo Gambacorta and Boris Hofmann. BIS Working papers N° 402; February 2013