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Improving Economic Governance in the EU[1]

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Summary: This ARI looks at the criticism of, and solutions to, Europe's economic governance that have been raised during recent years and offers a brief reflection on the slight improvements introduced in the Lisbon Treaty (2007), that remains to be ratified. It concludes with some reflections on the lessons that could be learnt from the current financial crisis and makes some proposals on the way forward.

Analysis:

Introduction
The debate on the economic governance of Europe has always focused on issues of coordination between the different member states. However, the focus has recently changed.

In 2007, the debate centred around need to agree on a new institutional Treaty that could overcome the Dutch and French 'no' to the Constitution. In this context, any discussion about economic governance referred to the economic limits that the EU would face as a result of the poorly functioning economic and fiscal coordination necessary in a monetary union. Many analysts agreed that this was causing asymmetric fiscal deficits, interest rates that did not respond to the real economic situation and a negative divergence in unit labour costs. In addition, there were complaints that economic reforms were not being applied, probably because the institutional design favoured inaction –a wait-and-see attitude– particularly if the measures to be taken were unpopular. As a result, the European economy was responding slowly and weakly to the challenges of globalisation and, therefore, was weakening the European project in the eyes of Europe's citizens.

In the Spring of 2008, the European Commission tackled some of these issues in its Report on the 10 years of EMU, but its prudent approach to reforming the economic governance of the euro area was quickly questioned by the need for stronger action to respond to the threat of financial collapse. Since then, and during the last quarter of 2008, the debate on economic governance has increasingly departed from aspects of joint structural reform and has focused on other important aspects such as the role of the European Central Bank (ECB), the need to harmonise banking regulations and, most importantly, the need to reinforce coordinated fiscal responses led by the Ecofin and the Eurogroup.

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Regardless of what motivates the debate on the economic governance of Europe, the object of discussion has always been one of its three basic elements: (1) the independent monetary policy formulated by the ECB; (2) the fiscal policy formulated by Member States but coordinated through the Stability and Growth Pact; and/or (3) the diverse reforms loosely coordinated by the Broad Economic Policy Guidelines (BEPG) within the framework of the Lisbon Strategy.

This three-pillar structure of economic governance was designed in the Maastricht Treaty (1991), but since the beginning of the Monetary Union in 1999 certain important problems in the system of economic governance have been identified, generally related to important asymmetries between the three elements mentioned. The failed Constitutional Treaty did not contain anything new regarding economic governance in Europe compared with the original architecture designed in Maastricht 14 years earlier.

The following pages analyse the criticisms and solutions to Europe's economic governance that have been raised during recent years, and offer a brief reflection on the slight advances that were introduced in the Lisbon Treaty (2007), that is yet to be ratified. It ends with personal reflections on the lessons that could be learnt from the current financial crisis, and makes some proposals on the way forward.

Debating the Governance of European Monetary Policy

Of the three elements that comprise the system of economic governance, monetary policy is the one to have received the least criticism in recent years. The main objections that have been raised regarding the ECB's independent monetary policy can be summarised as follows: (1) by focusing exclusively on price stability the ECB could worsen the problems of growth of Europe's most important economies; and (2) the ECB has acted 'too independently' in regard to the political opinions of the Finance Ministers of the Eurogroup and also to the opinions of the markets regarding the euro's value and exchange rate. In addition, it has been unable to adjust its monetary policy to its fiscal stance or to fulfil a possible accompanying role to make structural reforms easier.

Basically, the solutions that have been proposed go by way of including growth and employment within the EU's objectives (and perhaps within the ECB's statutes), along with price stability, similar to the Federal Reserve in the US. There have also been proposals to modify the method of selecting the ECB's Executive Board as a result of the growing nationalisation to which the bank is being subjected. Some authors have also defended the possibility of establishing an institutionalised mechanism for dialogue between the EU's Economy Ministers (that meet in the Ecofin) and the ECB, so that they can agree every three years on an appropriate inflation objective for the euro zone.

Beyond this debate, and strictly linked to the recent financial crisis, there should be a new discussion regarding the possibility of granting more powers to the ECB, not only in relation to monetary policy but also in a supervisory role for the European financial system. There are different arguments for and against a growing role for the ECB in the supervision of the financial system. What seems certain after the events of 2008 is that a stronger and more coordinated system of supervision and exchange of banking information will be needed in the future to prevent sudden cross-border systemic crises. This should take the form of either a new European System of Financial Supervision (based on a new financial agency) or on a new role for the ECB.

Debating the Governance of Fiscal Policy

This is the area in which most scholars have expressed their criticism. In some cases, the immediate implication of this criticism was that the monetary union would have worked perfectly within a fiscal union. To understand these arguments, it is necessary to take a brief look at the original design of the EMU's fiscal policy pillar.

The negotiations which led to the Maastricht Treaty were dominated by the alternative visions of France and Germany regarding the role that fiscal policy should play in the monetary union. While France proposed an 'economic government' that would ensure the 'essential' coordination of fiscal policies within the EMU, Germany put the emphasis on maintaining price stability through strong mechanisms of fiscal discipline. In fact, both positions were included in the Delors Report (1989) that stressed both the need to determine in a coordinated manner the EMU's fiscal stance and the need to limit the size of budget deficits. Finally, both requirements became the basis of the two pillars (the pillar of coordination and the pillar of fiscal discipline) of the Maastricht Treaty signed in December 1991.

Nevertheless, the legal force of the pillar of fiscal coordination was much weaker than the legal force of the fiscal discipline pillar. While article 104 of the Maastricht Treaty included a specific objective (the limit of 3%) and detailed a specific procedure of sanctions for infringement (later reinforced by secondary legislation contained in the SGP), article 99 reduced the strength of the pillar of coordination by means of a general proposition. Later, the creation of the Eurogroup in 1997 (as an informal forum for discussion and under the Ecofin) to compensate for the signing of the strict and detailed Stability and Growth Pact aggravated even further the imbalance between the two pillars.

The experience with the economic governance of the euro since its creation has demonstrated that, paradoxically, the pillar of fiscal discipline has not worked as well as expected and that of coordination has worked better than expected. In reality, the reform of the SGP in 2005 was inspired by this initial experience, but there are still many academics who continue to criticise the SGP as an instrument obsessed with fiscal discipline, but completely useless for fiscal coordination.

Proposed solutions in this area adopt several different approaches. The most Pro-European seem a poor match for the current political situation in the EU but they do aim to resolve various problems at once. On the other hand, less ambitious solutions might enjoy greater acceptance but would need several simultaneous legislative modifications which would complicate their implementation.

The most obvious option to improve the functioning of the pillar of fiscal discipline would be to improve the SGP reformed in 2005, by incorporating positive incentives to complying with the established limits and strengthening the sanctions mechanism for infringement. To generate positive incentives, access to certain European funds (perhaps those related to the Lisbon Strategy) could be tied to compliance with fiscal discipline. In addition, a mechanism could be established in which fines paid by those who do not comply with the SGP would finance a new specific fund destined for Lisbon policies in complying countries. This would eliminate the temptation for collusion between countries in the Council as generated by the current system (as seen when France and Germany used their veto in the Council to halt the Commission's proposal to punish them for excessive deficits in 2003). Finally, to improve the sanctions mechanism all the proposals should go towards giving the Commission a greater role in this area.

The most significant initiatives for resolving the problem of coordinating the fiscal policies of the different member states refer to the creation of a truly European fiscal policy designed and implemented by a supranational fiscal authority independent of member states, similar to the ECB in regards to monetary policy.

Although some scholars argue that there will be no fiscal coordination in Europe until the EU has a supranational fiscal authority, this idea is old and is already found in the original project for monetary union. The 1970 Werner Report said that in a European monetary union the margins within which fiscal policy should move each year would be decided at the community level. The McDougall Report (1977) also advocated a partial centralisation of the budget, suggesting that a monetary union would need a common budget that would cover at least 5% of the European GDP.

In spite of these initial references, the Delors Report (1989) –on which the Maastricht Treaty was finally based– abandoned these ideas and embraced what is known as the Brussels-Frankfurt consensus. According to this consensus, the way to deal with asymmetric shocks is to increase flexibility through structural reforms. This makes it unnecessary to have a European fiscal policy to stabilise economic cycles given that the SGP leaves a reasonable margin to incur cyclical deficits, while the ECB's monetary policy can easily deal with them through an active use of interest rates.

This Brussels-Frankfurt consensus is, in fact, based on two distinct but complementary academic theories: monetarist theory, which calls for a central bank limited in its power to stabilise the economy and which must focus on controlling inflation; and, on the other hand, real business cycle theory, for which the origin of cycles lies in technological shocks based on the supply side and in changes in the preferences of economic actors (unemployment is considered the result of a greater preference for leisure over work). In the worlds sketched by both of these theories, the best way to react to cycles is by maintaining a monetary policy focused on price stability and a balanced fiscal policy throughout the cycle.

However, there exists an alternative vision of the world with neo-Keynesian roots that has gained relevance since the last economic crisis in Europe, and even more during the recent financial crisis. According to this vision, economic cycles can also be the result of shocks in demand which originate in 'waves of optimism or pessimism' of economic actors and which influence them decisively in their consumption, savings and investment decisions. These demand shocks are similar to those which some of the central economies of the EU lived through between 2002 and 2005 (especially in Germany). In addition, 'waves of pessimism' can act as self-fulfilling prophecies as the fear of a recession paralyses consumption and investment and therefore produces a recession. The most recent examples can obviously be found in the recent financial crisis, in which banks were reluctant to lend to each other due to mutual mistrust. This immediately led to a liquidity trap, massive pessimism in the stock markets and finally a subsequent recession in the world's most advanced economies.

In a scenario such as this, what is needed is a supranational European fiscal authority capable of offsetting the deceleration of consumption and private investment by taking public action through a central government. In turn, if the crisis in demand manifests itself in an asymmetrical form in distinct countries it is necessary to establish an automatic redistributive mechanism through a centralised common budget with great stabilising capacity, and financed with some type of European tax independently of the contributions

of member states. Finally, under these assumptions, the role of the Central Bank would go beyond maintaining price stability and would try to help in growth and employment, smoothing interest rates and reducing the exchange rate to re-launch growth through increasing consumption, investment and exports. It is in this second scenario that the idea that a monetary union is not sustainable without a supranational European fiscal authority arises. On the one hand, the need coordinate a European fiscal response to spend out of the recession created by the financial crisis in 2008 has gained supporters for this approach. But, on the other, the need to develop an economic government (perhaps as the first step towards a political union) in order to legitimise the actions of this European fiscal authority, and the subsequent Treaty modifications, prevents most people from firmly defending this idea. This is a point to which I shall return at the end of the paper.

Debating the Governance of Economic Reforms
Since the launch of the Lisbon Strategy in the year 2000, the agenda for economic reforms for the EU has run parallel to, and sometimes in contradiction with, the agendas for social cohesion and sustainable development promoted during the following years. In addition, the confusion generated by the proliferation of reform objectives, and the weakness shown by the Open Method of Coordination, called for the revision of the Lisbon Strategy in 2005. At that time, the decision was to reinforce the economic aspects of the Lisbon Strategy, since all agreed that only through growth and employment can the EU guarantee the long term sustainability of its social and environmental model. In this renovation of the Strategy it was also decided to group all the monitoring reports of the previous distinct agendas under one umbrella (the National Reform Programmes, NRP) that would be coordinated in member states through the creation of a new figure (a Mr or Mrs Lisbon) who would give public visibility to the process.

Since then, member states have appointed Lisbon coordinators, prepared their NRPs annually and the Commission has assessed these programmes (with greater forcefulness every year). Without any doubt, since 2005 the new process has reduced the lack of coordination between the different reform agendas, but it has not managed to provide the Strategy with all the visibility hoped for. In addition, the progress made in many areas continues to be limited.

Despite advances, the risk that all the reform processes will again lack coordination is significant for two reasons: (1) from the Community point of view, responsibility for the areas of labour and microeconomic reforms (the core of the Lisbon Strategy) is in the hands of member states, and the Commission does not have sufficient instruments to lead them; and (2) from the Intergovernmental point of view, the actual overlap in many areas between the distinct formations within the Council induces dispersion rather than aggregation.

To solve some of these weaknesses a series of minor measures of a technical character have been devised, almost all to reinforce the role of the Commission in this process and to avoid the contradictions that are generated in the Council itself around its own role. Based on the work of Murray ('Closing the Delivery Deficit: the Future of Economic Governance in Europe', Centre for European Reform) and also incorporating other studies, the proposals can be divided into four groups:

(1) The Finance Ministers who meet in the Ecofin should select their own President, so that he can prepare an agenda for the medium term for that Council formation, and to cooperate closely with the Commissioner for Economic and Monetary Affairs in all the areas of economic reform.

(2) The Ecofin should be transformed into a 'supercouncil' with greater authority for all economic affairs than the General Affairs Council. Thus, the Ecofin would supervise all the Council sectoral formations that deal with aspects of an economic dimension, and that currently manage to put into effect initiatives rejected by the Ecofin, ignoring its criteria and going through the General Affairs Council (which is always the last stage before the European Council).

(3) The EU should integrate the Industry, Internal Markets, Energy and Telecommunications Councils into one Business Affairs Council, with the participation of the Industry Ministers of each country. This new Council formation would therefore have greater capacity to coordinate all macroeconomic reforms on which European competitiveness depends. This Business Affairs Council would be under the umbrella of the new Ecofin Council.

(4) The Commission should appoint its own Mr or Mrs Lisbon from among its commissioners and he or she should be given the rank of Vice President of the Commission. This person would do the work that is currently done by the group of Lisbon Commissioners, and would be responsible for proposing to the Council the integrated guidelines, drawing up the Community Lisbon Programme and supervising the application of the National Reform Programmes. The whole process should be improved with additional rankings that support naming-and-shaming.

Some Improvements in Economic Governance Under the Lisbon Treaty (2007)
With all the problems and proposals for improvement outlined in the previous sections, it is evident that an ambitious reform of the EU's system of economic governance would have required a complete section in the IGC launched in June 2007, that led to the final agreement six months later in Lisbon.

However, things did not work out that way. Given the need to save crucial aspects of the Constitution, such as the distribution of votes in the Council and seats in the Parliament, the division of responsibilities between the EU and member states, the presidency of the EU and the figure of the representative for foreign affairs, the fundamental questions of economic governance were postponed. Despite all this, and although there were no modifications made regarding the governance of monetary policy, some improvements were introduced in the governance of fiscal policy and in the processes of economic reform which are worth pointing out.

(1) Regarding fiscal policy, the modification which was introduced to reinforce the role of the Commission in applying the Stability and Growth Pact is important. To achieve this, article 104, section 6, was modified by substituting the word 'recommendation' for the word 'proposal'. With this small modification unanimity will be needed (everyone with the exception of the country to be sanctioned) to reject any proposed fine of the Commission. In this way, from now on, when the Commission proposes (and not only recommends) fines in applying the

procedures for excessive deficits, the probability of applying the sanction will be much higher and will avoid situations such as the Franco-German veto of 2003.

(2) In matters of coordination of economic policies, the new Treaty has included a modification of article 99 to reinforce the role of the Commission in this aspect. To do this, the following resolution has been added: 'Where it is established… that the economic policies of a Member State are not consistent with the broad guidelines… or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned'. In addition, coordination has been strengthened with the drafting of a new article 114 that, among other things, confers on the Council the responsibility to 'strengthen the coordination and surveillance of budgetary discipline', as well as 'to formulate broad economic policy guidelines' for member states, ensuring that they are compatible with those adopted by the rest of the Union (and ensuring that they are monitored).

(3) Finally, another important advance has been the inclusion of measures which give legal standing to the Eurogroup as contained in two new articles (115 and 115bis). In both, the existence and composition of the Eurogroup is recognised but, above all, it is given a fundamental mission: 'to establish common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences based on prior consultation with the ECB'. With the goal of providing only one voice for the euro in the world monetary system, the possibility that the Council will designate (after a proposal from the Commission) a 'unified representation within financial institutions and conferences' is also recognised. Or, in other words, designating a Mr or Mrs Euro to fulfil these functions of international representation of the single currency might now be a real possibility.

Conclusions: Clearly, progress towards an economic government has been put off, but limited advances in the resolution of some problems in the current system of economic governance have been made.

The events of these past months have shown the member states and the public that individual responses to global crises are useless. Only when the Eurogroup met at the highest level in early October 2008 and decided to coordinate a common framework to solve the financial crisis did the situation begin to stabilise in Europe. In my view this has been the definitive political legitimisation of the Eurogroup's role, and this opens the way to different speeds in economic coordination within the EU-27.

The recent financial crisis has probably changed the minds of many and should allow us to consider again some of the aspects of European integration that have been vetoed. For the time being, I believe there are a few minor and major reforms that need to be considered:

Minor Reforms (Requiring No Treaty Reform)

- The Eurogroup should become the leading body for economic policy coordination in the euro area, even more so when sudden shocks need immediate and strong coordinated fiscal policies.
- The Eurogroup should have a single voice and representation in the IMF and other international economic and financial institutions.

- The Ecofin Council should then be re-oriented to the discussion of broader legislation affecting the Single Market at the EU-27 level. It could incorporate some of the current Council formations in order to focus on European competitiveness.
- A new European Fund for deep shocks in the euro area could be established in the next financial perspectives (similar to the current Globalisation Fund) to facilitate joint responses to systemic crises.
- A formal mechanism of permanent dialogue between the ECB and the Eurogroup could then be introduced in order to better coordinate monetary and fiscal policy.
- The ECB could assume additional financial supervisory powers under the current treaty provisions.

Major Reforms (Requiring Treaty Reform)

- A new harmonised regulation for the financial sector, which could require a stronger supervisory role for the ECB, or the introduction of a new European Authority for Financial Supervision under a new European System of Financial Supervision.
- A new European Fiscal Authority (or a European Treasury) could be considered in the medium term. This new authority would lead the coordinated responses to systemic crises and would play a complementary role in helping national authorities during asymmetric shocks.
- A new EU Federal Budget would increase its current size from 1% to 5% of EU GDP, and would be financed by pan-European corporate taxes and other sources of supranational financing (such as taxes on carbon emissions). The new federal budget would finance new supply-side transnational programmes (on R&D, education, energy, environment and infrastructures) that increase the EU's growth potential. This new budget would include new mechanisms to link financial perspectives, Lisbon reforms and compliance with SGP.

Europe has been constructed step by step over the past 50 years in all areas, and this case will not be the exception. During the previous European recession (in the early 90s) many questioned the viability of the monetary union and now the euro has protected its members from major financial turmoil. Full economic integration will come about in stages, and political union, if it comes, will also be a gradual process; its slow rhythm can be the guarantee of a stable future.

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