

Iain Begg, Ansgar Belke, Sebastian Dullien, Daniela Schwarzer, Ramūnas Vilpišauskas

# European Economic Governance

Impulses for Crisis Prevention and New Institutions

Europe in Dialogue 2011 | 02



## Europe in Dialogue

The Europeans can be proud as they look back on fifty years of peaceful integration. Nowadays many people in the world see the European Union as a model of how states and their citizens can work together in peace and in freedom. However, this achievement does not automatically mean that the EU has the ability to deal with the problems of the future in a rapidly changing world. For this reason the European Union needs to keep developing its unity in diversity in a dynamic way, be it with regard to energy issues, the euro, climate change or new types of conflict. Self-assertion and solidarity are the fundamental concepts which will shape the forthcoming discourse.

“Europe in Dialogue” wishes to make a contribution to this open debate. The analyses in this series subject political concepts, processes and institutions to critical scrutiny and suggest ways of reforming internal and external European policymaking so that it is fit for the future. However, “Europe in Dialogue” is not merely trying to encourage an intra-European debate, and makes a point of including authors from non-EU states. Looking at an issue from a different angle or from a distance often helps to facilitate the crucial change of perspective which in turn makes it possible to continue to develop Europe in a meaningful way and to engage in a critical and yet courteous discourse with other civilizations and continents.

# European Economic Governance



*Iain Begg, Ansgar Belke, Sebastian Dullien,  
Daniela Schwarzer, Ramūnas Vilpišauskas*

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Europe in Dialogue 2011/02

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# **EU Economic Governance Reform: A Work in Progress**

*Joachim Fritz-Vannahme and Gabriele Schöler*

Dear Reader,

This is the fourth volume of the Bertelsmann Stiftung's Europe in Dialogue series, the purpose of which is to enrich the debate about the future of the European project by providing a forum for creative, innovative approaches to the pressing issues facing 21st-century Europe.

This volume addresses European economic governance reform, a burning topic for more than a year now. This volume contains four papers that provide considerable thoughtful input for dealing with economic crises in both the eurozone and the European Union as a whole.

We have invited five analysts from member countries to analyze EU economic governance reform and make constructive recommendations on how to move forward. The views expressed in these contributions are those of the authors, not the Bertelsmann Stiftung.

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From February to December 2010, the Bertelsmann Stiftung organized four expert roundtables in Frankfurt and Berlin under the heading “European Economic Government – Managing Heterogeneity.” The impetus for establishing the working group was the escalating debt crisis in Greece and the manner in which the European Union, the European Central Bank (ECB), and later the International Monetary Fund (IMF) were seeking strategies to address this unprecedented challenge.

During the course of the roundtables, events in the eurozone became ever more unpredictable with Ireland and Portugal the next members to seek multi-billion financial rescue packages from the European Union and the IMF, putting even more pressure on decision-makers to act decisively. Further aid for Greece is currently under discussion as this book goes to press.

The urgency of these events has given rise to a broader discussion about the nature and future of economic governance in Europe. Increasingly, the need for a thorough debate about reforming economic governance structures in the European Union was seen by the European Commission, the ECB, and national governments as essential for the future of the integration process.

Thus, on 24/25 March 2011 the European Council adopted a number of restructuring measures, the most prominent among them the European Stability Mechanism (ESM). In mid-2013 it will replace the current provisional safety net, the European Financial Stability Facility (EFSF). Other important steps toward EU economic governance reform are the reformed Stability and Growth Pact, the Euro Plus Pact for more Competitiveness, the new macroeconomic surveillance procedure, the European Semester, and the refurbished EU 2020 strategy.

In March 2011, the synthesis of the experts' group discussions was published as "Making the European Union Work: Issues for Economic Governance Reform." The group concluded that a number of crucial issues deserved further consideration:

*The Lisbon treaty embraces national debt brakes, which oblige governments to eliminate structural deficits over a defined period, to buttress the commitment of member states to sound fiscal policies. These should be controlled by national parliaments and overseen by European institutions, including the Commission, the Council, the European Parliament, the European Central Bank, and Eurostat, the EU statistical agency. The flip side is that this would result in six national and European-level institutions to oversee these debt brakes. The European Semester, the annual review process of national budgets, should be conceived both as an early warning mechanism to prevent future crises and as a means to drive forward structural reforms in order to improve the competitiveness of national economies.*

*A scoreboard of macroeconomic imbalances would better enhance the capabilities of national fiscal policies. But this should be accompanied by a wider scoreboard of defined progress toward the objectives of the Europe 2020 strategy, the new 10-year agenda for revitalizing the EU economy.*

*Despite some obvious shortcomings, our group notes the recent Franco-German proposal for a Pact for Competitiveness. Yet we have reservations about its narrow focus and the possibility that it puts too much emphasis on stability and not enough on growth. Under the European Semester this could supplement the European Council's political guidelines set out in early March 2011. National parliaments and governments would then draw up and submit structural reforms and stability and convergence programs in April. This decentralized*

*approach would help secure democratic legitimacy at home and at the EU level.*

*Naming and shaming would be built into any scoreboard. Automatic sanctions in a reformed Stability and Growth Pact (SGP) should be complemented by incentives. These would reward sound economic governance by increasing the European Union's funding of regional development projects. The European Systemic Risk Board would be empowered to sound alarm bells in all national legislatures and the European Parliament, not just the Council. Radical reform of the EU budget would embrace both the spending side (all investment would be linked to sound economic governance) and the revenue side by enshrining EU taxes. These twin innovations could be supplemented by a pan-European unemployment insurance scheme.*

*For cases of insolvency, the European Union needs a sovereign debt restructuring mechanism that fully involves the private sector ("haircuts"). The transition from the proposed European Stabilization Mechanism (ESM) and the European Financial Stability Facility (EFSF) to a European Monetary Fund (EMF) may be an answer. Aid from the EMF would be under the control of eurozone members (and their parliaments!) and strictly conditional.*

*Reconnecting financial markets to the real economy is urgent. A strict application of stress tests and (varying) minimum reserve requirements for banks under the Basel III agreement and a single regulatory framework for the financial sector under the new European System of Financial Supervision are essential.*

While a number of these issues have been approved by the European Council, there are still issues in need of further consideration. We have asked our five authors to take the decisions of the March summit into consideration in a review of their contributions to the working group over the past year. They analyze the issues, outline achievements, and highlight

inadequacies. Moreover, they make realistic proposals for addressing these shortcomings.

For example, to date only Germany has introduced a national debt brake that stipulates that the structural deficit must not exceed 0.35 percent as of 2016. Surveillance, however, happens on the national level.

Moreover, with the Euro-Plus Pact for more Competitiveness all 17 eurozone members plus Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania agree on more coordination of national economic policies with the aim of improving their competitiveness and convergence. They promise to take concrete measures on the national level and implement them within one year. The European Commission and the European Council will monitor implementation of the annual obligations on the basis of select criteria. Yet, critically, there is no clear focus on growth.

Also, the Stability and Growth Pact has been reformed. Sanctions (in the form of fines) can be imposed to prevent and correct macroeconomic imbalances. The Council will consider instituting quasi-automatic sanctions against those who break the deficit rule. Yet there are still only negative sanctions should states not comply. There are, to date, no financial incentives to reward good performance in the field of budget consolidation and economic policy, for example, through stronger support of regional infrastructure projects.

No concrete political steps toward a radical reform of the EU budget are planned. A separate EU tax is not in the pipeline, neither will the expenditure side be focused toward a solid economic policy, nor will any concrete measures toward a European unemployment insurance system be taken.

Above all, agreeing upon and implementing reforms requires political leadership that, as yet, the European Union has not shown.

This lack of political will and leadership – all of our authors concur – is the major hindrance to a full-fledged economic government (“gouvernement

économique” or “Europäische Wirtschaftsregierung”). In a nutshell, this means even more macroeconomic coordination at the EU level. As a consequence, the debate on EU economic governance is certain to continue, not least because of its wide-ranging social implications and its consequences for democratic legitimacy.

We hope this volume of our Europe in Dialogue series serves as a constructive contribution to the debate.

This publication would not have been possible without the combined efforts of many. We would like to express our gratitude to the authors for contributing their ideas and for delivering their essays on a tight deadline. We would also like to thank Paul Hockenos for his fine editorial work. A heartfelt thanks to all of you!

## **Prevent or Cure? Dilemmas Facing Economic Governance**

*Iain Begg*

Many of the problems that have come to light during the global economic crisis and in the “euro crisis” that erupted in 2010 reflect inadequacies in preventive mechanisms. Prevention is, in principle, about mitigating the risks associated with inappropriate economic policy choices. Ill-conceived policies can lead to adverse outcomes for the individual member states and often pay insufficient attention to uncertainties about the direction the economy will take. In a monetary union, a further concern is that wrong choices can have damaging spillover effects on others and thus push these others to unwanted policies.

The key challenge is to decide what should be prevented. Ultimately, macroeconomic stability is at stake, and the crises have shown that there are many facets to stability, notably fiscal sustainability and financial stability. Threats arise from imbalances, such as asset bubbles, divergences in competitiveness, and over-reliance on a particular sector of the economy, such as financial services and construction.

Since the launch of the euro, the main instrument for assuring budgetary discipline has been the Stability and Growth Pact (SGP). Prudential supervision has the primary role in preventing problems arising within individual financial entities that could endanger financial stability. Surveillance of wider economic conditions occurs under the Broad Economic Policy Guidelines through which the Council attempts to coordinate the economic policies of member states and to offer recommendations for policy changes.

But the crises made clear that there was a gap in the surveillance machinery in identifying systemic risks to financial stability. As the 2009 report of the high level group chaired by Jacques de Larosière stressed, what has become known as “macro-prudential” risk – arising from the spread of problems among financial intermediaries and between the financial sector and the public sector – was not adequately monitored (de Larosière 2009). Moreover, one of the principal conclusions from the troubles that affected the euro area in the spring of 2010 has to be that broader imbalances – both within and between countries – and divergences in competitiveness had not been given due attention. It is encouraging that the agreements consolidated at the March 2011 European Council offer a promising framework for doing so (European Council 2011).

Effective prevention can reduce risks. But the crises also showed that previously accepted economic assumptions can be wrong. In addition, new uncertainties surface, while phenomena that in the past had been considered latent or marginal suddenly assume greater importance. Certainly, the very high current account deficits of Greece, Portugal, and Spain should have been recognized as symptoms of imbalances and corrected by macroeconomic policy shifts to encourage higher savings. In Latvia, unsustainable FDI inflows that offset its high net imports ought to have been spotted – and acted upon – much sooner. The excessive credit creation by Irish banks and the effect it had on property markets were highly visible, yet no one confronted them in a timely manner, either with regulatory action or microeconomic policy changes to curb credit growth. The trouble was that flattering GDP figures (with the notable exception of Portugal) allowed policy-makers to overlook the gathering storm.

## **The governance and track record of prevention**

At a superficial level, the system for surveillance of budgetary policies, consisting of Commission monitoring and Council decision-making on excessive deficit, functions well enough. Excessive deficits were properly identified by the Commission throughout the first decade of the euro. The Council was less zealous in going further, notably in 2002 when the deficits of France and Germany were not pursued, highlighting the gap between analysis and corrective action. More generally, many of the coordination processes at EU level, which should contribute to prevention, had been bedeviled by inadequate implementation and weak commitment.

Yet it is not enough to focus on the respective roles of the Council and the Commission in policing excessive deficits. The wider surveillance of member states' trajectories, including fulfillment of the Broad Economic Policy Guidelines, has had less impact, suggesting that member states pay little heed to edicts from Brussels. The flaws in the Greek statistics – long known to insiders – ought to have been corrected much sooner. The underlying problem is that even when problems are correctly diagnosed, and it is by no means obvious that they always were, the scope for forcing member states to change is limited. Moreover, the current system relies excessively on narrow statistical indicators, and making the statistical framework more robust is, in the words of Jean Pisani-Ferry, “bound to remain a considerable challenge at EU level” (Pisani-Ferry 2010).

In practice, prevention functions primarily through “soft law” processes. Although the SGP has a preventative arm that derives directly from the EU treaty and is given legal force by Regulation 1466/97, it has functioned largely through peer and political pressures on member states. Moreover, since 1997 there has been no resort to the financial sanctions embodied in Articles 11 and 12 of Regulation 1467/97, the corrective arm of the SGP (compulsory, non-interest bearing deposits of up to 0.5 percent of GDP),

and 13 (translation of the deposit into a fine). Instead, member states that have breached the pact's terms have simply been admonished and subject to peer pressure, even where an excessive deficit has persisted.

The focus in Regulation 1466/97 on current budgetary balances can be justified as necessary for a well-functioning monetary union, but is clearly not sufficient because it does not identify problems that will either have a pronounced impact on future public finances or that are damaging to macroeconomic stability for other reasons. Spain illustrates this quandary: between 1999 and 2007 Spanish public finances were robust, with steady progress toward surpluses in the last three of the nine years and an average balance over the period just in surplus at 0.1 percent of GDP. Spanish public debt fell from 62 percent of GDP in 1999 to 36 percent in 2007 and, although it has ballooned during the crisis, was projected to reach only 69.7 percent in 2011. This is a rapid increase, but still well below the euro area average or, indeed, the German figure. Yet it is now clear that Spain's economic trajectory was unsustainable because the construction sector had become too large and was distorting the economy, with tax revenue over-reliant on the profits of this sector. The same goes for the taxation of financial services in the United Kingdom.

The country-specific recommendations (CSR) addressed to Spain in 2007 and 2008 as part of the surveillance process praise its success in reducing public debt. But they allude only briefly to inflationary pressures, the current account deficit, and developments in the housing market. Even in 2009, with the crisis well underway, the CSR only mention the decline in construction and the main advice to the Spanish government was to focus on employability and lessening segmentation in the labor market, to enhance educational reforms, and to boost competition in services. A similar story could be told about Ireland with the added ingredient of runaway bank lending, whereas the pathology in Greece was much more directly attributable to the public sector.

## Surveillance of public finances

Despite being the most developed form of prevention, effective measures to prevent unsustainable public finances remain elusive and evidence on budgetary discipline is mixed. Before the crisis, the deficits of some countries exceeded the 3 percent SGP limit, though rarely by much. However, the medium-term objective of “close to balance or in surplus” was habitually ignored and the debt ratios of many members of the euro area have remained persistently above the Maastricht threshold of 60 percent of GDP. Table 1 presents a simple count of the number of years for which different fiscal outcomes were achieved for the EU-15 (1999-2003) and the EU-25 (2004-2007) in the years leading up to the crisis. The very different macroeconomic conditions from 2008 onward would render any comparison difficult.

For EU-15, data from 1999-2007 show deficits over the 3 percent threshold were registered 30 times (see table 1). Adding the ten EU-10 countries that acceded to the Union in 2004 and taking their data for 2004-7 reveals that in only 34 percent of the 175 country/year cases were surpluses recorded, despite the fact that the 2004-2007 period was economically benign. In other words, fiscal consolidation should have been feasible.

These statistics confirm that the “close to balance or in surplus” aspiration was poorly respected and few countries achieved it consistently. Denmark, Finland, Ireland, Luxembourg, and Sweden were the exceptions among EU-15, as was Estonia in the EU-12. In contrast, excessive deficits were recorded in all nine years by Greece,<sup>1</sup> in five out of nine years by Italy, and in four of those years in Germany and Portugal. Hungary had an excessive deficit from 2004-07. Although a majority (16 out of 27) of EU-27

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<sup>1</sup> These data reflect revisions made since Greece passed the euro entry criteria.

member states reduced public debt between 1999 and 2007, the level of debt of the euro area as a whole remained stubbornly above 60 percent. The eight member states above this threshold in 2007 included France, Germany, and Italy, three of the four largest member states. The debt ratios of France, Germany, and the United Kingdom all increased between 1999 and 2007.

**Table 1: Overview of budgetary discipline in EU, 1999-2007**

	<b>Surplus</b>	<b>Deficit 0-3%</b>	<b>Excessive deficit</b>	<b>% Excessive</b>
<b>EU-15, 1999-2003</b> <b>(75 observations)</b>	29	32	14	18.7
<b>EU-15, 2004-2007</b> <b>(60 observations)</b>	26	18	16	26.7
<b>Sub-total EU-15</b> <b>(135 observations)</b>	55	50	30	22.2
<b>EU-10 2004-2007</b> <b>(40 observations)</b>	6	23	11	27.5
<b>Total EU-25</b> <b>(175 observations)</b>	61	73	41	
<b>% of cases</b>	34.9	41.7	23.4	

Source: Own elaboration using data from AMECO database

According to the Commission's autumn 2010 economic forecasts, only the three Nordic countries and Luxembourg are expected to have debts below 60 percent in 2011 among the EU-15, whereas nine of the EU-12 member states pass this test. More worrying is the fact that only five of the 17 euro-area members achieve the debt ratio, with seven of them (including Germany, France and Italy) projected to post debt ratios above 75 percent of GDP for 2011. This suggests that the largest member states have been fiscally less disciplined than most of the smaller ones. Because of their greater weight in the EU economy, it is worrying that they are less inclined to follow the rules. It also raises the questions of why prevention was unable to anticipate these deteriorations, and whether the reforms currently being introduced can lead to better outcomes, despite being rooted in a similar approach.

### **A broader agenda for prevention**

It became increasingly clear, especially after the Greek fiscal crisis of spring 2010, that surveillance of budgetary balances alone, even if paying attention to debt, was not enough. As noted, prior to 2008 the Irish and Spanish economies were poster boys of the euro area, enjoying rapid, largely non-inflationary growth accompanied by successful fiscal consolidation. In other words, nothing in their budgetary indicators predicted the precipitate increase in their budget deficits and the surge in debt. With hindsight, explanations are easy to find. In Ireland's case, asset inflation, especially in housing, exacerbated by excessive credit growth, is the obvious culprit, suggesting that attention should be paid to asset prices in surveillance. In Spain it was private debt, with its counterpart in a hefty deficit on the current account of the balance of payments.

More intractable problems are evident in the trends in competitiveness. German unit labor costs (ULC) were largely static between 2000 and 2008,

whereas Spain's increased by some 30 percent and those in Greece, Italy, and Portugal by about a quarter. Relative to Germany, the four "Club-Med" member states experienced a marked deterioration in one of the principal determinants of competitiveness.<sup>2</sup> The enduring remedy is to boost productivity and to overcome the supply-side rigidities that continue to bedevil some of the southern European countries. One silver lining of the events of 2010 is that these countries are belatedly confronting such shortcomings. In terms of wider EU economic governance, this is one reason why the Europe 2020 strategy has sought to link supply-side reforms more explicitly with the SGP and thus, by implication, with preventative measures. The Euro Plus Pact has similar ambitions, although how it will dovetail with the Europe 2020 strategy remains uncertain.

### **Focusing on imbalances**

Much has been said recently about imbalances, with some commentators going so far as to attribute the crisis largely to the reluctance – or inability – of policymakers to act on them in a timely manner. Imbalances can arise bilaterally or multilaterally in the structure of an economy or between short and long-term imperatives. Indeed, excessive deficits in public accounts are one among many forms of macroeconomic imbalances. Others include sizable balance of payments deficits or surpluses, asset bubbles, spatial disparities, and structural imbalances.

A taxonomy of imbalances is shown in Box 1 and can be thought of as a template for approaches to prevention.

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<sup>2</sup> In countries undergoing rapid structural change, small relative shifts in ULC can give a somewhat misleading impression of problems, but these shifts relative to Germany are so large that they cannot be explained away in this manner.

**Box 1: Imbalances and indicators for monitoring them**

Level	Nature of Imbalance	Indicators
Global	Savings/consumption	Current account of BoP
	Dependency on few key industries (e.g. oil)	Volatility in GDP
Intra-EU	Savings/consumption	Intra-EU trade balance
	Competitiveness	Trends in unit labor costs
	Attractiveness to investment	Inward FDI, standardized
Intra-member state	Sustainable public finances	Excessive deficit – short term
		Rising debt – long term
		Un-funded obligations (age)
	Private indebtedness	Level and growth by main sectors of economy
	Asset bubbles	House prices or similar index
	Industrial concentration or growth of activity	Share of GDP in branch relative to benchmark
	Spatial	Regional disparities in GDP per head
	Inequality	Gini coefficient

There can often be two sides to imbalances and one of the most enduring challenges in international economic policy coordination has been how to reduce the asymmetries in pressures on debtors and creditors to curb imbalances. At the global level, the acrimonious dispute between the United States and China over the under-valuation of the latter's exchange rate points to the nominal exchange rate as an adjustment mechanism. But it also demonstrates how hard it is to resolve. Within the European Union, nominal exchange rate flexibility is not a viable option. The members of the euro area are unable to alter their exchange rates, while the others are discouraged from doing so because exchange rate fluctuations undermine the single market.

Debtors have to act rapidly, or they will either face bankruptcy or be unable to borrow. Especially in an era of highly integrated financial markets, indebted economies sometimes have to find solutions within days or face default, as happened to Greece in spring 2010. Hence, markets already exert a powerful discipline on debtor countries, although one lesson from the unfolding of the Greek crisis is that markets alone did not do so rapidly enough. Creditors are not subject to such immediate pressures, but will still be affected if their customers have to retrench, as German exporters found in 2009. They are thus not without incentives to reduce imbalances.

Yet there are undeniable obstacles to effective burden sharing, aggravated by the fact that both public deficits and trade deficits are associated in public perceptions with fecklessness and surpluses with virtue. A challenge for preventative mechanisms is to devise indicators and procedures that function more symmetrically, yet do not penalize success. As the world's leading exporters, the Germans and the Chinese argue, reasonably, that their export achievements are the fruit of investment in new technologies, other forms of productivity enhancement, and wage restraint. For the European Union as a whole, German (and Dutch and Swedish) net exports to the rest of the world are beneficial. Moreover, trade imbalances

within the European Union may be helpful if the surpluses are recycled as investment in catching-up countries. Critics claim, however, that large surpluses result from holding down domestic demand and that, to this extent, they have “beggar-my-neighbor” effects similar to competitive devaluations. What all this points to is the fine line between benign and malignant surpluses. Preventative policies need to strike a balance in pressures to adjust, bearing in mind that markets already exert strong discipline on deficit countries.

A further complication is that unlike a fiscal deficit or public debt, both of which can readily be measured as a percentage of GDP, what constitutes an excessive imbalance is much less easy to identify. There is no simple threshold beyond which asset price increases become disruptive or which signal an excessive trade surplus. A boom in construction is fine if it can be financed and helps to fill gaps in infrastructure or property provision. But it can distort the economy if it goes too far or results in increasingly less viable projects being financed. Moreover, the fact that there are nearly always two sides to the imbalance (surpluses balanced by deficits; lenders offset by borrowers) means that identifying who should redress the imbalance cannot be ascertained by statistical indicators alone. Imbalances also arise inside any country and take on a variety of forms, including interregional disparities, with congestion and inflationary pressures in some areas, while high unemployment and emigration characterize less competitive localities.

### **Beyond the member state**

A further challenge for surveillance is how to contend with what can be called the adding-up problem. The risks for any member state depend in part on the policies that others adopt. Thus, monitoring and mediating the effects of policies that “spill over” could be a significant part of an EU-wide

preventative approach. At present there is no easy way to prevent the decisions of national governments from becoming an unsatisfactory aggregate for the European Union as a whole. This could arise in various circumstances: too many governments pursuing fiscal policies that are restrictive and thus exert a collective squeeze on demand or, vice-versa, that are lax, fuelling inflationary pressures; over-reliance on net exports as the principal source of growth; or a reluctance to implement politically difficult supply-side reforms, increasing the likelihood of macroeconomic imbalances.

All of these issues are especially salient for the euro area because, in setting interest rates, the European Central Bank has to take account of conditions in the euro area as a whole. It will act if it sees a threat to overall price stability, but not if it sees inflationary pressures or fiscal indiscipline in one or two member state. There is, consequently an incentive to free-ride because the responses of the central bank will be relatively minor. By contrast, where monetary policy and economic policy are at the same geographical level (the nation state), the central bank is likely to react more forcefully.

Steps toward “collective prevention” have been taken in recent annual cycles of the Lisbon strategy, notably with the publication of country-specific recommendations for the euro area as a whole. But this development raises intriguing governance questions. Who, for example, receives them? Who is responsible for responding to them in the absence of supranational bodies with remits covering budgetary or structural policies? How are burdens shared?

Part of an answer is provided by the new treaty provisions in Chapter 4 of Title VIII governing economic and monetary policies that offer additional, though very general, powers of coordination. At one level, Article 136 TFEU does no more than replicate for the euro area the provisions for all member states contained in Articles 121-126. However, its political significance is

that it allows the euro-area members to adopt stronger coordination and surveillance measures than apply to the European Union as a whole, albeit with the caveat that they be compatible with the latter. This appears to open the way for wide-ranging innovations because only a qualified majority of participating member states is required to take action. In addition, Article 137 (referring to a protocol) formalizes the existence of the Euro Group.

The protocol on the Euro Group is a simple, two-article document that specifies that participating ministers shall meet informally “to discuss questions related to the specific responsibilities they share with regard to the single currency,” and that the meetings shall be prepared by representatives of finance ministries and the Commission. Since it does not restrict participation to finance ministers, the door is open for other configurations of ministers to meet. This happened in October 2008 when heads of state and government met, and again on 11 March 2011 when they met to hammer out what is now called the Euro Plus Pact. The second article of the protocol reaffirms the practice of having a two and a half year tenure for the president of the Euro Group. This provision could be used to establish further political direction and leadership for the euro area. It is, however, bound to be highly sensitive for non-participating members who would fear the dominance of a caucus.

### **Possible solutions to strengthen prevention**

How might prevention work better? A first answer is self-evident: because there are so many variables that affect economies, surveillance has to be broader than budgetary indicators. In principle, Article 121(3) already provides a mandate in terms wide enough to cover any relevant variable. The same article provides for the Commission to issue a warning to a member state if its policies stray from the Broad Economic Policy

Guidelines (from 2010, these are the first six of ten integrated guidelines for the Europe 2020 strategy). The Council then, on the recommendation of the Commission, would make recommendations to the member state.

One innovation was the European Semester for public finances. It is an examination of the national budget before it is formally adopted, so that potential threats to stability can be corrected early. Finance ministers are understandably sensitive to this for two reasons: subsidiarity and the fact that any change in a budget is likely to have political as well as economic consequences.

But any system is only as good as the political will behind it and this is where better prevention has to start. There are two sides to this. First, the institutional framework and political conditions have to give member states sufficient reason to comply, which includes the likelihood of losses if they do not (whether to reputation or, conceivably, public finances). Second, the EU level has to demonstrate its seriousness of purpose, including quality of leadership and acuity of analysis, while providing room for member states to debate and shape the decisions, framework, and possible sanctions. Although the existing surveillance of fiscal policy has many of these ingredients, they have suffered from inconsistent implementation, pointing to another desirable feature of future policy. Surveillance in other areas ticks far fewer boxes and it is no surprise that it has had a limited impact.

Much is already on the table as a result of the van Rompuy task force on economic governance and the legislative proposals put forward by the Commission, all now broadly accepted. The proposals on better prevention can be accommodated under the Lisbon Treaty, although the new crisis resolution mechanism agreed at the December 2010 European Council will require a simple treaty change.

The further strengthening of surveillance is centered on four main themes:

- Reform of the SGP to increase the focus on debt and on long-run fiscal sustainability;
- Broadening the scope for macroeconomic surveillance to encompass a range of macroeconomic indicators and thus to identify imbalances likely to have damaging consequences. The excessive imbalance procedure (EIP) agreed by the European Council in March 2011, and now making its way through the EU legislative process, is a significant innovation to establish a mechanism similar to the SGP, encompassing a corrective arm that includes financial sanctions;
- Closer scrutiny of structural policies to check that the member state is making sufficient progress toward its Europe 2020 targets and is undertaking reforms that ease macro-fiscal difficulties. Country-specific recommendations would, as under the Lisbon strategy, be issued;
- A directive to oblige member states to establish “resilient and effective national fiscal frameworks” that will make it easier to conform to European Union and euro-area commitments.

Although modeling the EIP on the SGP is superficially logical, there are two potential flaws. First, while an excessive deficit procedure is in the treaty, there is no treaty basis for an excessive imbalance. Second, the breadth of possible manifestations of imbalance inevitably means that a judgement would be needed on what constitutes excessive – a recipe for disputes and equivocation. The design of the EIP allows for these concerns by building-in qualitative judgments. However, the viability of sanctions is open to question and raises new questions of legitimacy. For example, as a House of Lords report asked, should a government be penalized for either pursuing policies that make the country too competitive or for economic developments (for

example, wage-trends negotiated by the social partners) that are outside its direct control? There are also concerns about whether a slow-acting procedure can add much to what markets already do in disciplining errant countries (House of Lords 2011).

Nevertheless, it is hard to disagree with the thrust of these proposals, but the critical question is whether they will lead to remedial action when surveillance identifies problems. If a member state receives an assessment that says it is at risk from high housing prices, too high a level of consumer debt, or rising unit labor costs, various remedies could be contemplated. A macroeconomic remedy would be for fiscal tightening to dampen demand. Alternatively, structural policies that deal directly with the specific issue might be preferred, for example the imposition of regulatory constraints on mortgage lending or measures to boost innovation and productivity.

### **Barriers to improvements in prevention**

Although much could be achieved using the existing machinery and hard law framework, implying that the obstacles to effective prevention are largely political, they remain formidable. Nevertheless, they pose acute legitimacy and accountability challenges. In addition, there will inevitably be legal constraints because of subsidiarity and the assignment of competences in the treaty. Moreover, the specter of the Bundesverfassungsgericht, the German constitutional court, with its vigilance on transfers of sovereignty, is one of many that inhibit change. The question then is what would make more effective surveillance politically more acceptable.

As always, both carrots and sticks are needed. The current institutional set-up gives the final say to the Council, which leads to conflicting incentives around prevention. On the one hand, member states will want to

deter free-riding and adverse spillovers, and there is even the minor incentive for euro-area members that the interest earned on deposits or the proceeds of fines from sanctions imposed under the SGP will accrue to the other euro-area participants. On the other, member states sitting in judgment on their peers' breaches of rules or sound policies know that the tables might be turned in future, and they might therefore fear retribution. Condemning larger member states would be likely to be especially awkward for smaller ones that may subsequently need their support, possibly in an unrelated policy area.

There are obvious political pitfalls, demonstrated by the initially hostile reactions of several finance ministers to the proposals for a European Semester. For example, the U.K. Chancellor of the Exchequer, George Osborne, stated, "it is absolutely certain that future budgets will be presented first to the House of Commons."<sup>3</sup> However, subsequent statements suggested scope for compromise. Clearly, for the United Kingdom the dilemma is that it sees the merit of effective surveillance, but bristles at being subject to it. A possible inference to draw is that if such scrutiny can be massaged to fit in with national idiosyncrasies and to avoid treading on the wrong toes, it could make more progress. More broadly, any preventive diagnosis has to be complemented by a means of agreeing how to proceed. There are choices to be made about whether formal recommendations should be limited to identifying the difficulties that need to be addressed, or whether they should also include the politically sensitive question of "how?"

One of the more difficult areas is adaptation of national fiscal frameworks and how the new directive will operate. Some member states would like to see the commitments enshrined in national law, while others prefer administrative solutions. Better prevention is partly a matter of

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<sup>3</sup> In an oral reply to a question from Michael Fallon M.P. in the House of Commons, 8 June 2010.

implementation and there can be little doubt that some of the problems that have emerged in the aftermath of the crisis are attributable to shortcomings in delivery. Some member states have strong domestic institutions or (in certain cases) constitutional arrangements that constrain government discretion. For them, it is questionable whether there would be much added value in the imposition of further constraints from the European Union and the danger is that any such constraints would look like meddling. For other member states (naming no names) what is imposed top-down may well have a salutary effect.

A solution may be to move away from a one-size-fits-all to a more customized approach. But legitimacy will certainly be an issue. Why should country X be subject to a demand from Brussels that country Y escapes? An answer may lie, first, in the benchmarking of rules and, second, in the quality of communication of the principles and objectives of rules or procedures. In other policy domains where there is oversight from an external agency, it is routine to keep the subject of the oversight on a watch-list so long as it is seen as at risk. Then, if it fulfils whatever criteria apply, it would be left alone. To a degree, this is what the excessive deficit procedure does.

### **The link to dissuasion**

The obvious weak link in all of this is the credibility of the proposed sanctions if a member state does not comply. From a governance perspective, soft law devices are the first line of enforcement and, especially for the EIP, it is difficult to see the jump to financial sanctions being easily accepted. There is, therefore, a dilemma about whether prevention can be backed by more effective enforcement, with the possible Catch-22 that the sanctions are designed not to be used. It was, after all, commonly believed

that the fines envisaged in the corrective arm of the old SGP were equivalent to a nuclear deterrent that would never actually be deployed.

The Commission-van Rompuy package sought both to broaden the range of sanctions and to make them more graduated, so as to increase the likelihood that they will be used. This makes sense, but until it is put to the test it is hard to predict whether the proposed new sanctions regime will ever be used. It will be a major development in EU economic governance if a finance minister actually accepts a financial sanction – and hands over money. The proposed new reverse majority, which requires a majority against imposing sanctions proposed by the Commission, may go some way to tip the balance.

Jean Pisani-Ferry, among others, doubts whether a top-down solution can work and has called instead for an approach in which member states take steps to tie their own hands by, for example, enacting balanced budget laws. This emulates not only the U.S. states, which almost all have balanced budget rules, but also member states that have self-imposed constraints, such as Estonia which has a constitutional obligation to balance the budget and Germany with its new target of doing so by 2016. Prevention would thus come from below and the burden of EU-level surveillance would be reduced. In effect, the Commission proposal for a directive on national fiscal frameworks achieves this goal.

### **Legitimacy and communication**

Good preventative policies have to be justified and explained and, from the standpoint of legitimacy, surveillance has to navigate a number of hazards. Recipients of recommendations, let alone of sanctions, have to be convinced that what is proposed is fair and coherent. However, there is an unavoidable accountability gap when bodies such as the Commission are

perceived to have their own political agenda. A potential solution might be to create separate agencies charged specifically with adjudicating fiscal positions, macroeconomic imbalances or macro-prudential risks. But the danger is that this would add to rather than solve institutional complexity and accountability difficulties. Moreover, analytic capacity is a key requirement of prevention that is unlikely to be achieved by the proliferation of agencies.

A legitimacy challenge arises where any proposed economic policy will affect different interests in different ways, and even if it makes sense, may be bad politics. For example, the fiscal tightening advocated for Ireland in 2001 at a time when it had a sizeable budget surplus was almost impossible to defend in a country that had infrastructure deficiencies and less developed welfare services than most of its EU-15 peers. Plainly, too, public spending and taxation decisions often have distributive consequences. A key direction for reform of preventative measures is, though, to enhance the quality of public finances, notably to emphasize growth promoting spending, a possible corollary of which is to give less weight to purely redistributive measures.

Communication and explanation have to be better integrated into surveillance, both to render it more legitimate and to contribute to better policy outcomes by becoming an instrument of policy. A good example is the extensive debate in recent years on the role and scope of central bank transparency. This latter aspect of communication stems from the ability of the policy-monitoring agency to alter behavior by explaining why a decision has been taken or an opinion reached. Thus, if a central bank explains that its planned trajectory for interest rates is toward tightening, it can shape expectations in a way that diminishes inflationary pressures and might then obviate the need for an interest rate rise.

If recommendations with preventative aims are communicated with sufficient subtlety, they could have a similar effect. For example, if a

surveillance process concludes that a country is taking unwarranted risks with its fiscal policy, it would become a more potent recommendation if the messages were seen to be fair and based on well-founded analysis. Consistency would also be vital. Yet an abiding problem is when political judgment comes in and, in particular, under what circumstances political leaders are able to over-ride the outcome of surveillance.

More prosaically, communication has to emphasize and explain better what is already agreed. The public and many policy actors tend to be poorly informed about both the rationale for existing preventative measures and the means used to implement them. A good illustration is the “close to balance or in surplus” rule at the heart of the SGP that has been supplanted by a popular perception that the rule is a 3 percent deficit. Yet the whole point of the interplay between the medium-term balance objective and the 3 percent limit was to generate room for maneuver when there are cyclical variations.

If surveillance is broadened to include a wider range of indicators and more judgment, the need to communicate the principles and criteria will be all the greater. Long-term changes and obligations need particular attention. With population ageing coming increasingly close in most EU countries, the pressures on public finances will intensify because of ever-higher pension and care bills. To deal with these pressures, there is an evident need for governments to boost public finances by running surpluses now so as to build up future fiscal capacity in much the same way as several oil-rich countries have created sovereign wealth funds.

## Conclusion

Like preventative medicine, effective prevention of economic mistakes can help to avoid much more painful remedial actions. Yet change is beset by governance challenges. A shopping list of what would be desirable to enhance surveillance in a way that would diminish economic risks has to take account of constitutional and institutional obstacles and political sensitivities. There will, too, inevitably be disquiet about the democratic legitimacy of greater EU oversight, rule-based coordination mechanisms, and constraints on national political choice. A potential resort to financial sanctions as a means of imposing preventative discipline will be especially tricky in this regard, and most contentious where the government cannot entirely control the variable(s).

The reform and amplification of prevention that followed the euro crisis in the spring of 2010 is extensive. However, the new measures will take time to bed in and the proliferation of new measures (augmented since the end of March 2011 by the Euro Pact Plus with its uncertain connections to Europe 2020) could result in overkill. Some of the elements attract little controversy, but others must be expected to provoke strong reactions. Among the least controversial are the following:

- Ensuring that accurate and timely statistics are available. For statistics to play a key role in surveillance and in determining how rules are enforced, decision-makers must have confidence in the quality and integrity of the underlying statistics. Where figures prove to be unreliable or, worse, manipulated, the scope for bad choices is clear and the repercussions are considerable;
- A broadening of the range of indicators measured in assessing economic prospects. Since the relevant treaty articles already cover more than budgetary policy, there is no obvious constitutional constraint or political principle at stake, although there will always

be reservations about intrusion in areas reserved for national policy. There seems to have been no real objection to a sharper focus on public debt and the medium- to longer-term sustainability of public finances (notably in relation to ageing). Although conceptually more awkward, few commentators seem opposed to better surveillance of a wider range of macroeconomic indicators;

- Periodic health checks could be envisaged for member states, as envisaged in the Commission proposals for a macroeconomic scorecard. Although politically awkward, these might culminate in a sort of traffic light system (red for danger, amber for warning) to summarize the state of the economy under review. The obvious pitfall is that an EU-level agency, such as the Commission, has a negative image in many countries and, as a result, might engender adverse political reactions in member states, leading to poor compliance. It follows that it would be important to boost its analytic capacity and to ensure that it is perceived as independent.

Somewhat more controversial would be a closer connection between surveillance and significant policy shifts, whether in budgetary policy or supply-side policies. The initial antagonism of many finance ministers to the idea that Brussels examine their budgets before they are adopted testifies to the sensitivities. However, the subsequent agreement of proposals to have a European Semester before national budgets are presented for approval domestically suggests new thinking. But it remains to be seen how this will work when put to the test. Which finance minister will be first to genuflect to Brussels in planning a national budget?

Extending the reach of EU-level surveillance of financial stability will also be tricky because the national taxpayer is the guarantor of last resort of private debt and there is no EU-level taxpayer, rendering the case for top-down surveillance hard to make. But the advantage of an external process can be that it is less subject to domestic political pressures and a possible

agency to carry out this task would be the new European Systemic Risk Board. This would require strong political support and a willingness on the part of member states to comply with recommendations, which will not be easily achieved.

Sanctions are likely to be extremely contentious. What also needs attention is how to bring together the different strands of prevention. Also, the interplay between surveillance and enforcement has to be considered if prevention is to work. Very simply, if there are no costs associated with non-compliance, but potential benefits (even if these are short-term and populist, rather than better long-term economic outcomes) decision-makers may have few incentives to adopt unpopular policies.

There is also an underlying ambivalence about sharing sovereignty and accepting integrated governance. As Nicolas Jabko of Johns Hopkins University explains, this has been a longstanding quandary at the heart of economic and monetary union (Jabko 2011). It is again on the table as a result of the damage done by failing to sort out manageable problems in a timely manner. A resolution of these challenges transcends the issue of prevention.

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# Restoring Growth, Restoring Confidence: Advancing the Single Market and Structural Reforms in the EU

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The European Union can most effectively contribute to the long-term growth of the European economy in four major ways. Firstly, by extending single market principles to the member states' economies, which are still fragmented by national regulatory differences as well as energy and other infrastructure markets. This would increase competition and reduce transaction costs. Secondly, it should further open the single market to external global competition through the liberalization of multilateral and regional trade. Thirdly, Brussels should facilitate structural reforms in the member states foreseen under the Lisbon strategy and now under Europe 2020. And, lastly, the European Union should improve the quality of institutions by strengthening their ability to implement policies, improving the coherence between policies and governance, and reducing administrative burdens.<sup>1</sup>

My argument focuses on the main factors of economic growth that are influenced by European economic governance, including EU institutions, decision-making procedures, and policy-specific rules that impact conditions for long-term growth either by prioritizing certain policies (the single market) or by influencing it indirectly (the coordination of national structural reforms).<sup>2</sup> Of course, many issues of economic governance remain the

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<sup>1</sup> Promoting the sound fiscal policies of its member states is increasingly important for EU institutions. It is, however, not discussed in this paper as it is a subject of other contributors.

<sup>2</sup> This is a simple way to avoid discussing the complex notion of "governance." For a discussion of governance see Markus Jachtenfuchs and Beate Kohler-Koch's

competence of the member states. They include, for example, the definition and enforcement of property rights; regulation of labor market, education, and science; and the redistribution of resources. On the other hand, not all EU rules strive to contribute to long-term growth since in some cases this might be incompatible with other objectives, such as regional cohesion. Moreover, in some policy areas, such as Common Agricultural Policy (CAP), the European Union might have other objectives. For example, the income levels of farmers might be prioritized over economic growth. Finally, current debates on European economic governance often refer to the monetary and fiscal policies of the eurozone (extended to Euro Plus Pact in March 2011), which are clearly important for growth but not the focus of my argument.

Long-term economic growth was one goal of the Lisbon strategy, adopted in 2000, and also of its successor strategy Europe 2020, presented in 2010. One of the weaknesses of the Lisbon strategy was its very broad scope that included numerous, diverse policy areas. It also set multiple, sometimes incompatible, objectives for national and EU policies. As the Commission acknowledged, the original strategy “gradually developed into an overly complex structure with multiple goals and actions and an unclear division of responsibilities and tasks, particularly between the European Union and national levels” (European Commission 2010, 2). Europe 2020 aimed to narrow the number of targets and focus on key policy areas

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“Governance and Institutional Development” in Wiener, Antje and Diez, Thomas *European Integration Theory*, Oxford: Oxford University Press, 2004, p. 99. They define “governance as the continuous political process of setting explicit goals for society and intervening in it in order to achieve these goals. The European Commission has also reflected the academic debates on governance by providing its own definition of European governance, which “refers to rules, process and behavior that affect the way in which powers are exercised at the European level, particularly as regards openness, participation, accountability, effectiveness and coherence” (European Commission, *European Governance, A White Paper*, COM (2001) 428 final, Brussels).

important for achieving long-term growth with particular focus on strengthening the institutional aspects of its implementation.

I am fully in agreement with other experts such as Belgium economist André Sapir who concluded in 2004: “The main reason behind the poor growth performance of the European Union in the past seems to be related to the supply side of the economy. In particular, the significant obstacles which still remain to complete the integration of markets – most notably of labor markets and of certain segments of financial markets – as well as the failure to improve regulatory framework and carry out the structural reforms needed for a competitive, dynamic and innovative economy” (Sapir, 90). This diagnosis also seems on the mark against the background of the European Union’s economic crisis and developments in the eurozone. Interestingly though, these crises also present a window of opportunity to advance certain, overdue policy measures. Moreover, it has usually been after periods of economic stagnation or decline that new projects of European integration have taken shape. The crises and current debate could thus provide a welcome push for measures to increase competitiveness.

### **Relaunching the Single Market**

Usually, the single market’s extension is not discussed as an issue of economic governance. To a large extent, the principles of the "Community method" have already been applied to decision-making concerning single market issues. Nevertheless, it is the area where the European Union clearly has an important role to play in its division of competences between the Union and the 27 member states. Moreover, the creation and consolidation of the single market has a direct impact on the intensity of competition and allocation of resources inside the EU economy. As others

have argued, "making the single market more efficient is Europe's best endogenous source of growth and job creation" (Monti 2010, 10). Also, despite the adoption of Program 1992 almost two decades ago, existing barriers to the single market are still significant and underscore the potential that could be released by removing those barriers. Finally, governance is important not only in cases where there is a lack of EU rules and its coordination role is weak, but also where the European Union does not deliver. If it persists, this failure to deliver is likely to damage the European Union's credibility and its member states' policies.

Although the single market went into effect in 1993, after initial euphoria it increasingly became clear that many areas of economic activities in member states are still protected from European competition by differences in national regulations and by the fragmentation of infrastructure. Many services and network industries such as energy are not part of the single market because they are characterized by the patchwork of national regulations that act as barriers to trade inside the European Union.

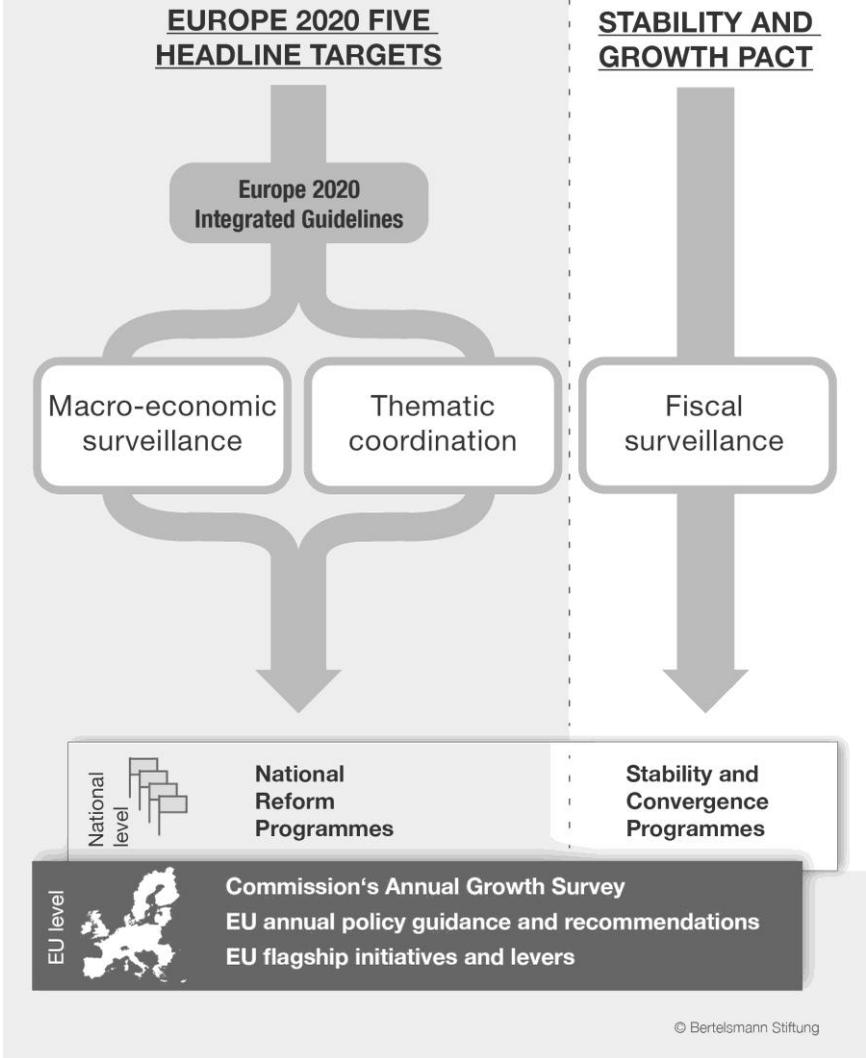
Mario Monti's 2010 report, "A New Strategy for the Single Market," provides a good update of the current state of the EU single market as well as directions for its further extension (Monti 2010, 3). The room for the extension of the freedom to provide services in the European Union is illustrated by the fact that the services directive, which is being implemented in member states, covers less than half of all services, while services contribute to more than two-thirds of EU GDP. The fact that around 70 professions in Greece are protected from internal EU competition illustrates the current limitations of the single market. The extension of single market principles in such areas does not require financial resources, unless it is decided to provide some kind of support to those who find it hard to cope with "the" restructuring in the face of growing competition. Such a relaunching of the single market requires political consensus, leadership, and regulatory measures.

The financial element of relaunching the single market project is more important for the infrastructure projects that aim to connect more isolated parts of the European Union. This is particularly relevant in the case of the energy market, which is characterized by regulatory and infrastructural fragmentation. It also remains relevant to the transport sector. This kind of fragmentation prevents EU businesses and consumers from taking full advantage of the single market (and EU membership in general). Directing more EU financial resources to such projects in the next EU financial perspective, at the expense of less productive investments without increasing the budgetary ceiling, could be a measure consistent with the overall aims of consolidating the single market, increasing competitiveness, and fostering growth. Moreover, the chances of creating a common external EU energy policy are rather poor until there is a truly integrated internal energy market. The European Council recently underscored the need for a “fully functioning, interconnected and integrated internal energy market,” and 2014 is when gas and electricity are supposed to “flow freely” in the European Union (European Council Conclusions).

Turning to the issues of governance, the key challenge for relaunching the single market project is addressing the lack of political consensus and slow enforcement of the single market principles in EU member states. To put it differently, the issue here is not the lack of treaty provisions but the actual application of treaty principles in practice by either issuing secondary legal norms or simply overseeing the enforcement of treaty principles. The gap between the provisions of the treaty and the actual achievements in removing barriers to trade and entrepreneurship inside the European Union is an outcome of popular skepticism, lobbying of interest groups still keen to be protected in their national markets, and the corresponding unwillingness of EU political elites to move ahead with consistent application of the single market principles to the areas of economic activities, trade, and movement of factors of production. Therefore, the main question is how to build

## Governance, Tools and Policy of Europe 2020

Source: EU Commission



support for such an initiative and to ensure its appropriate delivery on the ground.

Monti proposes a way forward that is accepted in Brussels and is likely to be followed by the European Commission in coming years. After stating that the “single market today is less popular than ever, while Europe needs it more than ever,” he suggests a “comprehensive approach,” the essence of which is finding a compromise between different visions of the European economy (Monti 2010, 6). Such a “package deal” in which different member states with different traditions and political preferences could find roles that appeal to them and allow them to reach consensus should include removing barriers to not only the four freedoms, but also to social services, active industrial policy, regional development policies, and tax coordination.

It seems that the European Commission has accepted the recommendations of the Monti report on the Single Market Act and a parallel initiative on harmonizing the corporate taxation basis. The measures of the unofficially publicized “competitiveness pact” discussed by Germany and France in early 2011 also seem to point to a similar logic of bundling different policy initiatives that in addition to strengthening the competitiveness of the European Union also include suggestions on taxation policy. Finally, the 25 March 2011 European Council conclusions also included similar references to “robust action at the EU level to stimulate growth by strengthening the single market” and to reforms required to move toward Europe 2020 goals as well as “pragmatic coordination” of tax policies. The latter have been presented in Annex 1 under the Euro Plus Pact section, implying the possibility of follow-up measures only among the member states belonging to this recently formed grouping and respecting the integrity of the single market (European Council Conclusions). It is quite likely that further debates in 2011-2012 will focus on particular elements of such a package deal, with some member states favoring further removal of regulatory barriers to trade and competition in the provision of services and

other still-protected fields, while others promote harmonization of tax regimes and EU-wide rules, and the European Commission tries to find common ground to reach a deal on relaunching the single market project by 2012.<sup>3</sup>

The most questionable element of such a package deal is not the need for political consensus, but rather the collection of different policy measures based on a different economic logic. Thus, while the extension of the single market seems to be “win-win” for all by contributing to competition and a more efficient allocation of resources in the Union, the coordination of taxes – possibly leading to harmonization – is based on a different logic. Moreover, if there is a political need to soften the impact of a growing competition and facilitate adjustment to restructuring pressures, a targeted financial assistance to companies facing difficulties along the lines of the current European Globalization Adjustment Fund would be a more effective measure than some kind of tax harmonization. Besides, in terms of legitimacy, until there is no “true European political arena” and politics remains “an essentially national pursuit,” direct taxation matters should remain domains of the individual member states (Project Europe 2030, 40).

Therefore, although the need for some kind of relaunch “package deal” is understandable, it should be based on a clear functional logic. Its elements should be complementary and coherent rather than a collection of policy items. Moreover, there is another important element in this project: the need for very clear communication of the benefits of the single market to EU citizens. The long-established, expert-insider consensus on the benefits

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<sup>3</sup> The initial package of 50 proposals was presented by the European Commission for public consultation in autumn 2010. See Communication of the European Commission, Towards A Single Market Act: For a Highly Competitive Social Market Economy 50 Proposals for Improving our Work, Business and Exchanges with Each Other, COM (2010) 608 final/2, Brussels, 11 November 2010.

of the single market and its extension contrasts sharply with the popular skepticism or indifference to this aspect of the European Union.

The current economic slowdown could be used as a window of opportunity to relaunch the single market if there is the right mix of leadership, pooling of resources, and a well-prepared action plan with increased attention to the details of enforcement and proper information to the citizens regarding the benefits of this project. There seems to be growing momentum for such a relaunching. Take, for instance, several initiatives, including the “growth letter” signed by the leaders of nine EU member states and presented just before the March 2011 summit (Getting Europe Right). The focus of this initiative signed by the leaders of the Nordic and Baltic countries, as well as the United Kingdom, Netherlands, and Poland, is clearly on the completion of the EU single market and opening it up to outside competition. If coupled with a renewed drive of the European Union to complete the WTO Doha Round of trade liberalization, it could provide a welcome contribution to the facilitation of long-term growth and the narrowing of the gap between rhetoric and practical policy decisions.

### **Narrowing the gap on global trade policy**

Since the creation of European communities, the treaty has stated that “progressive abolition of restrictions to trade” is the key objective of its Common Commercial Policy. The EC/EU indeed played a significant role in multilateral negotiations and over the decades lowered its external protection level significantly. It also led the waves of regional trade liberalization agreements with different countries around the world. Although it has been a matter of debate whether the European Union is a leader of world trade liberalization or is on its way to becoming “fortress Europe,” its

businesses and consumers benefited significantly from participating in the global trade and investments networks.

However, the last decade witnessed difficulties in the process of multilateral trade liberalization. The WTO Doha Round is stalled. There has also been little progress in trade liberalization across the Atlantic, although the European Union managed to negotiate some free trade agreements with countries in other parts of the world, for example, with South Korea. It seems that the international trade system and its institutions withstood the pressures of economic decline and its accompanying economic nationalism with only a relatively small share of trade being affected, especially when compared to the protectionist turn of the 1930s.<sup>4</sup> However, the gap between rhetoric at the G-20 and EU summits about the need to complete the Doha Round and the lack of any progress in this respect has become increasingly obvious. Also with little impact were the calls of analysts and international institutions framing the benefits of the Doha Round in more political terms and arguing that its conclusion would create greater security of market access and strengthen symbolically and substantially the WTO's role in restraining protectionism.<sup>5</sup>

The benefits of international trade for the economic welfare of all countries involved have long commanded a remarkable consensus among

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<sup>4</sup> Assessments of the scale and effects of protectionist measures along the continuum of "glass half-empty – half-full" vary. See, for example, Evenett, S. J. *Broken Promises: A G-20 Summit Report* by Global Trade Alert, London: Center for Economic Policy Research, 2009; European Commission, *Fifth Report on Potential trade Restrictive Measures in the context of the Global Economic Crisis*, November 2009; European Commission, *Sixth Report on Potential Trade Restrictive Measures in the context of the Global Economic Crisis*, May 2010; Erixon, Fredrik, Sally, and Razeen Trade, *Globalization and Emerging Protectionism since the Crisis*, ECIPE Working Paper, February 2010.

<sup>5</sup> See, for example, Hoekman, Bernard, Martin, Will, and Mattoo, Aaditya. *Conclude Doha. It Matters!* World Bank Policy Research Working Paper 5135, November 2009.

economists of different theoretical camps.<sup>6</sup> However, recent attempts by the European Union and other WTO members to further facilitate trade by removing existing barriers to trade have been ineffective and increasingly overshadowed by discriminatory measures introduced during economic decline. While the difficulties of further liberalization are partly an illustration of how far trade liberalization, at least in non-agricultural products, has advanced in recent decades, there is still room for progress.

As with the relaunch of the single market, the voices of interest groups unwilling to be exposed to global competition are louder than those that truly benefit from it. Lack of political leadership seems to be the major barrier. The European Union has exclusive competence on most matters concerning its external trade policy. It is the mandate given to the European Commission to negotiate with other WTO partners, rather than the lack of legislative instruments, that limits progress. The negotiations are also complicated by the importance of regulatory issues and the tendency of the European Union to extend its regulatory norms to its trading partners.

The gap between rhetoric and practice in international trade damages the credibility of the European Union and other major WTO players. Interestingly, the Europe 2020 strategy does not explicitly call for concluding Doha. However, it maintains that an “open Europe, operating within a rules-based international framework, is the best route to exploiting the benefits of globalization that will boost growth and employment” (Europe 2020). Although the need to conclude ongoing multilateral and bilateral trade negotiations has been acknowledged, it seems that more emphasis has been given to the enforcement of existing rules.

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<sup>6</sup> For the most recent works on globalization and international trade, see Legraine, Phillippe. *Open World: The Truth about Globalization*, London: Abacus, 2002; Bhagwati, Jagdish. *In Defense of Globalization*, Oxford: Oxford University Press, 2004; Wolf, Martin. *Why Globalization Works*, New Haven, Yale University Press, 2004; Irwin, Douglas. *Free Trade under Fire*, Princeton: Princeton University Press, 2009.

Reducing ambitions is one way to close the gap between rhetoric and practice. The other way would be to progress with less complex goals than those concluded at Doha, which could include reducing the use of commercial protection instruments, extending the free trade area to neighboring countries, creating a transatlantic free trade area between the European Union and NAFTA, and supporting the enlargement of WTO membership, in particular, to include Russia. Moscow is an important EU trade partner but also an active user of protectionist measures during the economic crisis. Although concluding Doha would be the best-case scenario, second-best options are still preferable to an international trading system where the European Union retreats into internal affairs and becomes permanently stuck between ambitious rhetoric and mediocre performance.

Recent developments provide cautious grounds for optimism. Despite the fact that Europe 2020 has been largely silent on the Doha Round, debate has been revived by a recent High Level Trade Experts Group report (Interim Report). The report recommends a 2011 deadline, by which negotiations would conclude ten years after their start. Such a scenario would require EU member states to review their agreement on CAP reform, possibly linking this process with upcoming negotiations on the next EU financial perspective. At times of fiscal austerity this might become politically easier to agree upon than it has in the past. In March 2011 the European Council explicitly called for the conclusion of the Doha Round in 2011 (European Council Conclusions, March 2011, paragraph 8). However, it would require coordinated effort and leadership on behalf of the European Union and key member states, which can be difficult to achieve with elections looming in some EU countries.

## **Effective facilitation and coordination of structural reforms in member states**

The importance of structural reforms is another area where there is broad agreement among analysts and EU institutions.<sup>7</sup> These reforms include increasing the flexibility of labor markets; reform of education, science, and social policies; and fostering entrepreneurship and innovation. The record after a decade of implementing the Lisbon strategy is mixed, as the Commission has acknowledged.<sup>8</sup> In contrast to the Common Commercial Policy and internal market-related issues, the role of the European Union in coordinating the structural reforms of its member states has been indirect and limited to providing a forum for the exchange of best practice, peer review, and public evaluations of progress toward commonly agreed goals (short of 'naming and shaming'). In other words, the open method of coordination (OMC) that the European Council defined in Lisbon in 2000 has been the governance method behind the European Union's role in structural reforms aimed at jointly defined policy objectives and performance indicators.

OMC has mostly acted as a forum for the coordination and alignment of narratives about reforms, raising awareness of other member states' experiences while at the same time resulting in different national policy outcomes with no dominant patterns. The studies of Europeanization tend

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<sup>7</sup> For example, the Reflection Group called for "urgent structural reforms with a view to enhancing flexibility, competitiveness and dynamism," presenting the issue as a choice for the EU between reform or decline (Project Europe 2030, p. 15). The term "structural reform" refers to "changes in structural policy settings directed at improving static or dynamic resource allocation in the economy" (Tompson, William, and Price, Robert. *The Political Economy of Reform. Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*. Paris: OECD, 2009, p. 16).

<sup>8</sup> See European Commission, *Lisbon Strategy Evaluation Document*, Commission Staff Working Document, SEC(2010) 114 final, Brussels, 02 February 2010, and the Lisbon Scorecards compiled each year by the Centre for European Reform.

to agree that even when the impact of such “hard” legislative instruments of EU governance as regulations and directives is evaluated, there is little evidence of the complete convergence of national practices. Therefore, it should not come as a surprise that “soft” coordination methods do not produce the strong alignment of member states’ policies and their convergence toward uniform EU targets. The key issue is how the European Union can better contribute through such governance instruments by helping member states to advance their structural reforms by solving the national political and economic dilemmas and by streamlining the overall EU governance processes to have more focus, clearer priorities, and better coordination between different institutional layers, time frames, and policy fields.

The field including the political economy of structural reforms has identified a number of factors that can influence the success of reform efforts or at least can present windows of opportunity for such reforms.<sup>9</sup> These include the economic cycle (the presence of economic crisis), the political cycle (proximity of elections), and informing the public about the costs and benefits of reforms. Moreover, it is also maintained that fiscal deficits can complicate reforms in the short term while proper sequencing and synergies between different reforms can facilitate them. Being a member of the European Union and participating in its governance structures can facilitate reform efforts by helping to strengthen the positive influence of some factors or by reducing the possible negative effects of others.

Thus, participation in the Lisbon process and now in the Europe 2020 strategy allows for the extension of the time horizon beyond the next

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<sup>9</sup> For the more recent studies see the OECD’s *Going for Growth. Economic Policy Reforms*, 2007. OECD, 2007; Tompson, William, and Price, Robert. *The Political Economy of Reform. Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*, Paris: OECD, 2009.

national elections, and for strengthening institutional memory and expertise. In such a way, it might strengthen incentives for structural reform. Improving information flow based on the experiences of other member states as well as evaluations of different practices and recommendations allow for better-informed policy choices that can be used to strengthen the case for structural reforms and better explain the benefits of such reforms. Coordination of information flow presents opportunities to align reforms in member states and to search for better national synergies.<sup>10</sup> Also, extension of the single market might reinforce some national structural reforms, for example, by increasing labor market flexibility or opening up some of the services to competition from other EU member states. Crossborder health care services, for example, might eventually strengthen the push for structural reform in this sector.

More tangibly, at a time of economic decline and severe budgetary constraints the European Union is providing financial resources that can be used for the purposes of structural reforms in such areas as education and research or health care. Of course, in such a way the role of EU governance is one of facilitation and enabling member states to move toward national and Union-wide goals, while the decisions are taken at the national level and responsibility remains mostly within member states (except for the “blame the EU games,” which are a matter of politics rather than an actual division of roles in the process of structural reforms). Despite all of the shortcomings of this process, there are no convincing reasons to alter this division of powers by shifting them to the supranational institutions in these key areas of member states’ competences and thereby “hardening” the coordination process. Rather, there seem to be possibilities for better-

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<sup>10</sup> The Lisbon strategy itself was called “a comprehensive, interdependent and self-reinforcing series of reforms” (Kok, Wim. Facing the Challenge: The Lisbon Strategy for Growth and Employment. Report from the High Level Group Chaired by Wim Kok, November 2004, p. 8).

focused, more synchronized and better-enforced European economic governance processes that could add more transparency, efficiency, and effectiveness to the complex multilevel polity.

Analysts and the EU institutions have already addressed the streamlining of the governance structures to make national reform efforts more effective. After the first years of implementing the Lisbon strategy and following the 2004 Kok report, the European Commission introduced changes to the coordination of national reforms within the framework of Lisbon.<sup>11</sup> The number of targets was reduced, measures aiming to forge partnerships in the member states and strengthen the sense of ownership of national authorities were undertaken, and more emphasis was placed on country-specific recommendations (first adopted in 2007). However, the Lisbon strategy, relaunched in 2005, was still criticized for lacking both focus and adequate instruments to meet its objectives. Some analysts suggested turning the Europe 2020 process “into a proper benchmarking exercise, with naming and shaming” (Tilford and Whyte 2010). Similar ideas have been voiced by the Reflection Group, which suggests strengthening the link between common guidelines at the EU level and their implementation at the national level “through an effective ‘name and shame’ peer pressure mechanism, as well as positive incentives, financial and otherwise. Last but not least, assessment procedures should focus on outcomes rather than inputs or processes” (Project Europe 2030).

The Commission responded by presenting “Europe 2020 for Smart, Sustainable and Inclusive Growth.” It proposed a limited number of goals: five measurable EU targets for 2020 to be translated into national targets,

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<sup>11</sup> “Overloaded agenda, poor coordination, conflicting priorities” and “the lack of determined political action” were mentioned in the report as the main shortcomings of the Lisbon process of reforms (Kok, Wim. Facing the Challenge. The Lisbon Strategy for Growth and Employment. Report from the High Level Group Chaired by Wim. Kok, November 2004, p. 6).

which proposed to lift the ownership of the strategy to the highest political level (the European Council was suggested some years ago by the Kok group), and defined the EU contribution through flagship initiatives. The reporting and evaluation of both the Europe 2020 strategy and the SGP are to be undertaken simultaneously implying concurrent reporting by member states on their convergence and national reform programs (see the Annex 1). This process started in 2011 in the form of reinforced, integrated surveillance to address key macroeconomic challenges combined with a thematic approach to speed up growth-enhancing structural reforms, the process referred to as a European Semester. The enhanced coordination of economic policies should include a strengthened ex-ante element, with policy guidance issued by the Council focused on a concrete and limited number of policy reforms with set deadlines.<sup>12</sup> The strategy also discusses instruments to prevent deterioration of competitiveness through stronger macroeconomic surveillance, including alert and sanction mechanisms linking disbursement of EU cohesion policy support to structural and institutional reforms.

The Europe 2020 strategy was adopted by the European Council in June 2010. The Council acknowledged that the strategy will constitute a framework for “enhanced coordinated action” and “promote delivery of structural reforms.” The leaders of the European Union also stressed that “the emphasis now must be on implementation, and we will guide and monitor this process.” Concrete surveillance, preventive and corrective measures, and the details of enforcement mechanisms were discussed by the European Commission and the Task Force on economic governance in autumn 2010. Although most of these mechanisms are expected to deal with fiscal imbalances of the eurozone countries, the progress toward

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<sup>12</sup> See Communication of the European Commission on Enhancing Economic Policy Coordination for Stability, Growth and Jobs – Tools for Stronger EU Economic Governance, COM (2010) 367 final, Brussels, 30. June 2010.

nationally agreed targets and implementing national reform programs, as well as trends in competitiveness of EU-27, will also be monitored and coordinated by more targeted, country-specific measures. The European Council of March 2011 endorsed “the priorities for fiscal coordination and structural reform” within the newly started European Semester to be followed by member states’ measures required to advance toward Europe 2020 goals, the evaluations of the European Commission of each country’s stability, convergence programs and National Reform Programs and its recommendations that they be followed up at the June 2011 summit (European Council Conclusions, March 2011, paragraphs 2-6).

Economic decline and the Greek sovereign debt crisis pushed the European Union and its member states toward streamlining economic coordination, as experts had repeatedly proposed for over a decade. The direction of governance reforms is toward a limited number of targets, more aligned and coherent policy processes, and strengthened incentives for the enforcement of reform programs.

However, there are also limits to such streamlining efforts, which extend beyond the legal need to respect the treaty. The remaining complexity of EU targets, their different nature, and different strategic processes, as well as hesitancy to apply sanctions, is an inevitable result of the diversity of attitudes, various stakeholders with vested interests in particular EU policies, bureaucratic inertia and, most importantly, member states’ reluctance to introduce sanctions that might be used against them in the future. Although the perceived need to avoid a similar crisis of public finances and competitiveness in the future and the proposals from the key player of the European Union (and eurozone) – Germany – are likely to shift the coordination of policies toward a new equilibrium, it remains to be seen to what extent it will solve the problems of governance, in particular the delivery gap. Many recent measures presented under the European Semester are mostly about the better enforcement of the economic policy

principles and norms that have been either part of EU law or have been suggested by various actors for many years. However, if the European Union and its member states succeed in gradually aligning with those policy principles that are considered to make “sound policies,” this could in time become a “historic” achievement as pronounced by the president of the European Commission in the aftermath of the March 2011 summit.

### **Improving the quality of institutions**

The quality of institutions is an important factor affecting long-term growth. Though member states are responsible for most norms and institutions that affect the economic activities, allocation, and redistribution of resources in Europe, the European Union influences the quality of institutions in a number of ways. Since it is an issue of horizontal nature important for implementing different public policies, it is an important element of the previously discussed EU policy measures. It is therefore only briefly singled out here as a separate issue. The main directions of improving the quality of governance include closing the delivery gap between commitments and actions that characterize many policies ranging from structural reforms to trade liberalization, improving the coherence of different policy processes, and levels of policy making, reducing the administrative burden, and improving transparency.

Each of these directions could be detailed further, for example, by suggesting that the European Commission use such models of regional project management like the Baltic Energy Market Interconnection Plan. In addition to financing EU priority projects, it allows for solving coordination problems among subgroups of EU member states and monitoring the implementation of regional infrastructure projects as well as proceeding with

initiatives such as Better Regulation, for example, to reach the goal of reducing the administrative burden by 25 percent by 2012.

## **Conclusions**

In terms of substance, the key issue is to deliver results such as the extension of the single market principles to the economic activities still fragmented by national regulatory differences and infrastructural bottlenecks, opening the European Union further to participation in the global division of labor and better use of its comparative advantages. In these policy areas the governance instruments are already in place. The challenge is to find political consensus and leadership to use the treaty provisions to be implemented by drafting secondary legal norms and simply enforcing the treaty principles in member states.

In other areas, such as the coordination of national structural reforms, there are possibilities to further improve policy coherence by either adopting policy measures that can reinforce each other (for example, provisions of health care services which can reinforce the reform of the health care sector in the single market). Another possibility might be streamlining different coordination processes between the European Union and its member states, as recently suggested by the Commission and approved by the Council. These proposals seem to go in the right direction by reducing the number of EU-wide targets involving the main political actors and by reinforcing incentives for the actual implementation of national reform plans. The quality of governance is likely to improve if the credibility and effectiveness of EU policies are strengthened. Although there are limits arising from the diversity of interests and the need to respect sovereignty, a better communication policy to inform both the public and leaderships is critical. They must understand that the current situation of economic

uncertainty could provide the right window for establishing a new equilibrium of EU governance and integration that could restore economic growth and confidence in the European project.

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# **Euro Area Crisis Management: Consequences for Convergence and Institutional Follow-Up**

*Ansgar Belke*

In order to establish an excessive debt prevention and resolution mechanism for the euro area, a recent Commission communication on "Reinforcing economic policy coordination" states that "a clear and credible set of procedures for the provision of financial support to euro-area member states in serious financial distress is necessary to preserve the financial stability of the euro area in the medium and long term" (European Commission 2010a).

The current EU instruments that address debt and liquidity crises include the European Financial Stability Facility (EFSF), the European Financial Stabilization Mechanism (EFSM), the European balance of payments instrument, and the European macro-financial assistance instrument. Of these, the EFSF and the EFSM are temporary in nature (three-year terms), and the other instruments do not apply only to non-euro-area member states. In terms of an efficient future crisis management framework, it was heavily debated what would follow the EFSF and the EFSM when they expire in three years' time. What kind of governance should follow the rescue packages in terms of permanent institutions and decision making?

This paper addresses the medium-run and long-term political and economic consequences of establishing the EFSF and the EFSM. Moreover, it assesses what needs to be done in the window of opportunity of the next three years, namely from the commencement of the EFSF in 2010 to its mandate's end in mid-2013. Which institutions, if any, need to be formalized, and what shape will they take? This paper evaluates

alternatives for establishing permanent instruments to support the euro. Clear from the very beginning is that any new mechanism should contain rules on decision-making procedure, funding, conditionality for loans, monitoring, as well as resources and powers to facilitate borrowing and lending activity in exceptional circumstances. It must also facilitate the orderly resolution of sovereign debt and private debt of major financial institutions.

### **Background: Governance of the euro area**

Where do we stand? In light of the history of the European Monetary Union (EMU), what are the consequences of the recent rescue package in terms of long-term institutional solutions? There is still unfinished business concerning sound governance of the euro area. Investors were briefly impressed with the “cold turkey” rescue plan launched on 10 May 2010. European policymakers showed they were capable of agreeing on dramatic measures (Annunziata 2010, Sinn 2010).

Rather soon, however, investors realized that the gigantic rescue package was directed toward support for the weaker members in the form of a huge stabilization fund and direct ECB sovereign bond purchases. At the same time, there was a clear lack of action on fostering fiscal discipline and improving cooperation in the event of crisis. There is overall agreement that the euro area in its current institutional shape lacks the ability to enforce fiscal discipline. In this light, some investors and commentators have even expressed their doubt about the euro’s survival. The underlying problem is that the Stability and Growth Pact (SGP) is neither sustainable over time nor enforceable. There is no mechanism that overrides national sovereignty (Annunziata 2010, Sinn 2010).

Since the start of the EMU, the official political line has been to praise the SGP as the institutional mechanism best suited to guarantee fiscal discipline and coordination. But any assessment of the first ten and a half years has to acknowledge that one member country, namely Greece, has in the meantime turned to the IMF to avoid bankruptcy, and that the entire euro area appeared and partly still appears vulnerable to a systemic debt crisis (Neumann 2010). Why and how did it all go wrong?

First, a currency union cannot work without a high degree of economic integration (Krugman and Obstfeld 2009, 565). Second, the euro area has not created credible incentives for fiscal discipline. On the contrary, the creation of EMU has lowered incentives by eliminating the exchange rate risk at the country level. At the same time, a perceived “implicit bailout” insurance scheme induced lower credit risk premia and sovereign bond yield spreads. This kind of interest rate convergence based mainly on soft budget constraints is the opposite of what the founding fathers of the euro area had in mind (Annunziata 2010, Sinn 2010). Moreover, it is the result of rating agencies that want to avoid publishing stand-alone ratings of countries that would rightly exclude the difficult to quantify and politically biased convergence effects of sovereign bailouts.

It thus did not come as a surprise that fiscal convergence did not happen and some countries have run unsustainable fiscal deficits and/or accumulated huge stocks of public debt. In parallel, it proved rational for markets to ignore this lack of convergence. It appeared a safe bet that, if necessary, a member country would be bailed out by its partners. The irony is that for ten and a half years the markets behaved exactly how the ECB said they should. In other words, they looked at the euro area as *a whole* rather *than at individual* countries. The convergence of interest rates that the SGP targeted did manifest itself de facto in the EMU period until the financial crisis set in, but for the wrong reasons (Annunziata 2010).

Once some countries' irresponsible fiscal policies upset markets, a "passive" fiscal integration, namely the support of weaker members via loans subject to conditionality, turned out to be the only way to keep the euro area together. The implicit bailout clause defined above was thus converted by a toggle switch into an explicit one in the form of the rescue packages. Admittedly, member countries are not formally taking responsibility for one euro-area member country's liabilities. Thus, there is no breach of the treaty's letter. But the treaty's spirit is not upheld because the bottom line of all of these measures is that no euro-area member country, no matter how blatantly it offends the rules of the game, will be left out in the cold (Annunziata 2010). The key choice facing the task force under EU President Hermann Van Rompuy was: should the Union direct its efforts at preventing failure (including open-ended fiscal support),<sup>1</sup> or should it also prepare for the failure of a member state in order to mitigate the consequences should it fail (Gros 2010b)?

"The first choice is bound to imply elaborate measures designed to deliver "more of the same," namely a strengthening of the SGP, for example, with more provisions for economic policy surveillance and cooperation. So far at least, it seems that most member states (and EU institutions like the Commission and the ECB) were publicly only considering this approach" (Gros 2010b). But this approach did not provide any answer to the fundamental question of what to do if the currently chosen three-year framework doesn't work. As long as EU political leaders

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<sup>1</sup> With the Securities Markets Programme (SMP) in place and having bought significant amounts of Greek and other PIGS debt after May 2010 also within its normal refinancing operations and the emergency liquidity assistance programme (which was mainly directed towards Ireland), the danger has risen that the ECB will get caught up in the maelstrom of its role of a lender of last resort. The more bonds the ECB buys, the more difficult it will be to deny further sovereign financing in the future because doubts on the markets will prevail until an institutional solution of debt restructuring is installed as a fiscal agent to be financed by the governments themselves and not through the creation of money (see Belke 2010).

were not able to answer that, financial markets would have continued to be unsettled by doubts about the euro's long-run stability (Gros 2010b). This might have been the reason why, for instance, other solutions such as an insolvency mechanism for countries, taking into account an insolvency risk larger than zero, were discussed and played through secretly behind the walls of German ministries before the ESM was decided upon.

We have to keep in mind the lessons learned so far. For one, the euro area cannot stabilize in political and economic terms without a framework for crisis resolution and without the capacity to cope with sovereign default by a euro-area member state. If one adheres to the view that member states cannot be allowed to fail this logically implies that a political union or, at the minimum, a fiscal union must complement the euro. This is the decision that European political leaders and also the European Parliament inevitably came to in the last quarter of 2010: either a drastic step forward toward more political or fiscal integration, or a clear framework to match and to cope with the effects of a member country's failure to obey the rules of EMU.

In the latter case, no more integration would have been necessary, but just the courage of political leaders to publicly admit failure. No amount of money would have allowed European leaders to circumvent this issue (Gros 2010b). It is, thus, important to state that the exact amount of money contained in rescue packages is only of second order importance when assessing the impacts and the success of such a package. Of first order importance was and still is a public commitment by politicians to one of the alternatives.

## **Consequences of the EFSF and EFSM**

It is critical to underline that there are important analogies between the consequences of the establishment of the EFSF and the EFSM, and the effects of the Securities Markets Programme (SMP). I argued in my June 2010 briefing paper for the European Parliament that around May 9/10, 2010, markets might not necessarily have behaved in an irrational manner. On the contrary, their fear of not getting their money back was realistic. Facts clearly spoke against the idea that both the huge interest rate spread increases and the drying out of markets are really “dysfunctional” phenomena: Greece’s and also Portugal’s domestic savings were so small that these countries were not capable any more of keeping their capital stock constant and financing their public deficits. Looking at the development of sovereign bond spreads after the implementation of the rescue package, this informed guess and minority view has been clearly corroborated.

Admittedly, the establishment of the EFSF and the EFSM buys limited time for more systematic action, in much the same way the SMP did. However, again in the same way as the SMP, it introduces an element of subsidy that tends to weaken the fiscal discipline of euro-area member countries. The interest rate premium on bonds of fiscally weaker countries is intended to decline and the premium for stronger countries is intended to increase as soon as bad weather returns in the form of setbacks in Ireland or Greece. If installment of the EFSF and the EFSM is successful, fiscally solid countries would be punished and the less solid ones, in turn, would be rewarded for their lack of fiscal discipline and excess private and public consumption. The credit risk would thus be rolled over from the bonds of the weaker countries to those of the stronger ones if the window of opportunity would not be used for credible consolidation in the weaker countries and sovereign default is a probable issue.

It is no contradiction that, according to recent evidence, Germany has even gained in the short run in terms of its bond returns vis-à-vis, for instance, Ireland, as long as the rescue package does not have a too high probability to be activated. This is again a further piece of evidence in favor of the view that bond markets are not dysfunctional and because they differentiate between specific country risks. However, the current scenario is a fragile construction because if an emergency strikes, things might quickly change and markets will anticipate Germany's high financial burden within the rescue package. So everything hinges now on the credibility of budget consolidation in the weaker countries. This credibility is still rather low in cases of countries like Greece which have not aimed at the most promising consolidation mix in times of near bankruptcy, according to which two thirds consist of expenditure cuts and one third being tax increases (Alesina and Ardagna 2009) and in which there is no unanimous drive in the society to strictly stick to the adjustment programs imposed by the Troika..

Effects of the rescue packages have to be assessed against the fact that the previously booming PIGS are in deep economic crisis and Europe is currently struggling to arrive at a new equilibrium in accordance with the real constellation of country risks. The most important aspect of the temporary rescue packages then is that they impact on the speed of equilibrium reversion since they tend to slow down the speed and potentially also diminish the scope of short to medium-run sovereign bond yield differentiation in the euro area. This observation has to be attuned with a second, probably dominating one.

That is, the crisis will also have long-term implications for the euro area since budget constraints in the previously booming PIGS will be tightened for many years. This pattern is due to significant capital flows out of these countries that take place because the assessment of country risk by investors has fundamentally changed. German economist Hans-Werner Sinn accordingly argues that "investing funds in Greek state bonds, the

Spanish construction industry or U.S. mortgage backed securities is no longer seen as attractive since the fear of default dwarfs all promised returns” (Sinn 2010, 18).

According to the data, investors have dissociated themselves from their view that country risks only consist of exchange rate risks. The common fears that the former “southern” weak currency countries eroded their national debt by an inflation-cum-devaluation policy have thus simply been substituted by the possibility of private and sovereign debt defaults (Sinn 2010, Burda and Wyplosz 2009, 343).

Markets now anticipate events they had not previously thought possible. Thus, they claim compensation for the perceived risk by means of interest premiums. As mentioned above, for instance, a closer inspection of the pattern of the euro-area country sovereign bond yield spreads (or, equivalently, of most other investment categories) vis-à-vis Germany supports this view. In the first few days after the first rescue measures the spreads declined somewhat just to increase again afterward. This was probably due to a lack of credibility: the rescue measures were limited to three years and there no agreement in the French-German axis. In other words, the markets felt that the packages did not address some of the key, underlying issues. Moreover, they anticipate that in the end claims by public creditors whose share is steadily increasing in the PIGS' foreign debt will be senior in case of insolvency and want to be compensated for that.

In principle, this can represent a beneficial correction of markets that curbs the overheating of the capital importing PIGS as a result of soft private and public debt constraints. Quite independent of the political decision-making process, the market is now enforcing the necessary debt discipline and putting an end to the regime of soft budget constraints that pervaded the euro area (Sinn 2010). If this is true, the economic effects of the EFSF and the EFSM have to be evaluated with respect to their low effectiveness. At any rate, the interest rate data clearly support the view that

the rescue measures currently do not have the potential to stop the self-correction process initiated by the markets. Already a month after the agreement on the EFSF and the EFSM, the bond yield spreads surpassed previous levels. What is more, they have from time to time been on a much higher level than before the EU debt crisis (Sinn 2010).

Regarding political consequences, it was not quite clear in the second half of 2010 what the reactions of EU leaders would be to the fact that the markets, which were frequently condemned after the financial crisis, proved to be the only effective means to cope with soft sovereign budget constraints. This seemed to imply that the political decision-making process is probably not involved in the long-run problem solution to these soft constraints – at least as long as no exit of a member country from the EMU was foreseen. This is something I call the “first political consequence” of the EU governance status quo.

The rescue measures as of May 2010 were intended to reduce the risk of country defaults for a maximum duration of three years as well as to diminish interest spreads. With this mechanism, the rescue package has potentially reestablished the prior capital flows and thus unnecessarily extended the high growth period of the PIGS. This is because the package subsidizes capital invested in the PIGS by means of socializing the risk of default. This might be called the “first economic consequence” of the EU governance status quo at that time. As German economist Hans-Werner Sinn put it, “they ultimately entail a softening of budget constraints and promise little good for Europe” (Sinn 2010).

A second-order economic problem would consist of a further initialization of capital flows that were already excessive before. Projects with an inferior marginal rate of return would continuously be financed that would, according to standard growth models, lower the growth of aggregate GDP in Europe. This could be labeled the “second economic consequence” of the status quo. In the worst case, the default risk would become even larger

due to poorer growth prospects, with potential contagion of all euro-area member countries (Sinn 2010). A default of the major European countries would then have unpredictable effects on the political stability of Europe. In a sense, this represents the “second political consequence” of the institutional status quo in the euro area. As stated above, increasing bond spreads in the euro area could well be interpreted as an early warning sign that markets did not trust the rescue packages.

Just to summarize: the good news contained in the above analysis is that market-led equilibrium reversion (i.e. convergence) without political intervention might generate more balanced growth in the euro area, smoothing out the external imbalances within the euro area. An increase in prices and wages will reduce, for instance, Germany’s competitiveness and foreign account surplus (Gros 2010a). This macroeconomic result corresponds with the vigorous demands of French officials like finance minister Christine Lagarde. However, this pattern is produced in an endogenous fashion rather than exogenously by means of government-led wage negotiations, as a consequence of the redirection of capital/savings flows and the induced economic boom (Gros 2010a, Sinn 2010). However, this process may take time, something in between a complete business cycle and a decade because some restructuring of the labor force is involved. For instance, within the PIGS, labor has to move from the non-tradable to the tradable sector, which might lead to political resistance.

### **New institutions and/or modes of decision-making?**

The European Union and the EMU were and are in dire need of a model of economic policy management that, on the one hand, delivers more than the hitherto implemented fiscal coordination and the latest ad-hoc responses to the crisis and, on the other hand, a solution that cannot circumvent market

forces but has to live with them. Many political and economic actors label this kind of management “economic governance.” What it actually means in EU institution circles is a more effective management of national fiscal policies, and the monitoring and correction of negative macroeconomic developments like the lack of convergence in growth and a permanent crisis mechanism (Heinen 2010).

The Council agreed on “first orientations” regarding economic governance on 17 June 2010. With respect to fiscal policy, the effectiveness of the medium-term objectives of the preventive arm of the SGP has to be enhanced, for instance by employing sanctions, national budget rules, and medium-term budget planning by EU member states. Government debt, both its level and its trend, must play a bigger role in the SGP. In addition, stability programs for euro-area countries and convergence programs for non-euro-area countries were envisaged to be presented for screening to certain European institutions before their adoption from 2011 onward in the framework of the European Semester. The aim of the “orientations” is to reach better coordination and to arrive at timely action in case of negative developments. Quite important in view of the Greek case, independent statistical authorities have to assure the quality of statistical data. The agreements on stricter macroeconomic surveillance stipulate the application of a scoreboard for an assessment of the trends in competitiveness and macroeconomic imbalances, and identifying negative developments in a timely fashion (Heinen 2010).

Ideas for joint economic governance were under discussion in the task force headed by Mr. van Rompuy. Important position papers were published by the Commission (12 May and 30 June 2010), the European Central Bank (10 June), and the finance ministers of Germany and France (21 July 2010) with proposals for European economic governance (Bundesministerium der Finanzen 2010, European Commission 2010a, ECB 2010a). A closer look at them is highly recommendable because it discloses important viewpoints

of the main players when it comes to decide upon the new governance structure.

These position papers contain both proposals for effective coordination of fiscal policy and macroeconomic surveillance, as well as proposals for future crisis mechanisms for the European Union and the euro area. The proposals of new modes of governance in terms of institutions and decision-making share similarities, but there are also remarkable differences between them. Their most striking similarity is that they direct their efforts solely at preventing failure instead of preparing for the failure of a member state. This is hazardous because of the nearly unchanged macroeconomic problems of Greece, Portugal, Spain, and Ireland. What is more, as long as no member country is allowed to go insolvent, the euro area can continue to exist only if all its members act in a cooperative manner.

### **Institutional alternatives to support the stability of the euro?**

The preventive arm of the SGP is intended to enable more extensive intervention in national budgetary policy in the future, with a stronger focus on the sustainability of government debt and the condition that national budgets must be run compatibly with the SGP. Sanctions proposed by the Commission, and the German and French finance ministries, consist of the lodging of interest-bearing deposits by member states not complying with the medium-term objectives of the preventive arm. The ECB did not issue concrete proposals for sanctions, but did so for surveillance mechanisms. It proposed the introduction of an independent fiscal agency to conduct permanent surveillance (Heinen 2010).

With respect to the corrective arm, there was discussion about speeding up the excessive deficit procedure (EDP), and imposing quasi-automatic sanctions together with a reversal of voting arrangements. The latter implies

that Commission proposals would then have to be rejected by a qualified majority of the Council. It is important to note that, in contrast to this, at present they must be approved. This last proposal, which referred to a new mode of governance in terms of decision-making, stems from the ECB and reaches further than the provision originally agreed upon by the European Council. This meant there was no prospect of its implementation for the time being because it could mean a treaty amendment (Heinen 2010). Moreover, its democratic legitimacy was at stake.

The final recommendation made by the Commission and the Franco-German duo was the introduction of a European Semester. The Semester consists of a phase in the first six months of the year during which the national budgetary policies and the economic policies of member states are coordinated for the following year (Heinen 2010).

A common feature of all macroeconomic coordination proposals is that they proposed an installment of an early warning system accompanied by intervention measures administrated by the Commission. However the individual proposals came up with different indicators, and different types and severity of sanctions. As expected, the strictest stance was taken by the ECB. It proposes sanctions that are modeled on the EDP. Closely connected with this Heinen (2010) points to an interesting Franco-German proposal to enter into a political arrangement when voting is being conducted to achieve a de facto denial of voting rights. This proposal would not require a treaty amendment and, thus, serves democratic legitimacy.

Finally, all proposals called for a crisis mechanism for countries in serious difficulties. This mechanism could only be set in action under strict conditionality to minimize the risk of moral hazard. The ECB also published proposals regarding the establishment of a euro area crisis management institution, which would have many of the features of the EFSF (Constâncio 2010). Also, and especially from the ECB's perspective, it is crucial to minimize the risk of moral hazard, which is always implicit in any ex ante

rescue mechanism and might impact on medium-run expectations of inflation. “Strong conditionality, reproducing the EU/IMF financial support to Greece, and graded sanctions in case of non-compliance with conditionality, escalating to a de facto loss of fiscal autonomy as the extreme form of sanction” (Constâncio 2010), would be institutional safeguards. While the Commission’s proposals emphasized solutions and compliance with certain conditions, the ECB’s focus was on sanctions. This is tougher but could hold even greater potential for conflict. “Currently, however, this does not present an acute problem as the existing crisis mechanism (EFSF) will not need to be replaced until 2013” (Heinen 2010).

Some of the ideas set out in the Commission’s June 2010 Communication on enhancing economic policy coordination for growth and jobs were close to the ECB’s proposals (European Commission 2010b). However, for instance, Constâncio (2010) argues that the ECB’s proposals were somewhat more ambitious because they “feel that the situation requires a quantum leap forward in strengthening the foundations of EMU and moving towards a deeper economic union” (see also Bini Smaghi 2010).

### **The position paper proposals: an assessment**

Heinen (2010) presents an excellent synopsis of the position papers and also assesses the proposals. Heinen’s conclusion is that the European Commission, the ECB, and the German and French finance ministers have clear papers that are not grounds for optimism. Their analysis of the underlying problems is lucid and focused. The recommendations, however, according to Annunziata (2010) and others, indicate that we are about to repeat the same mistakes of the past.

The suggestion of the Commission to introduce a more comprehensive framework of ex-ante policy coordination, with a European Semester, aims at keeping individual countries to their fiscal targets and avoiding persistent intra-euro-area imbalances (Belke and Schnabl 2010). But it is left open what could actually force countries to change their budget plans according to the Commission's recommendations. The Commission also proposes that countries exceeding the SGP deficit ceilings should be forced to set aside funds in interest bearing deposits. But again, as Annunziata asks, "what makes us think that these interest bearing deposits would be enforced, when the fines already envisaged in the SGP have never been levied?" Commission proposals would then have to be rejected by a qualified majority of the Council. But in scenarios like the current one in which the qualified majority of member countries have preferences that go beyond the notion of EU economic governance as a mere hardening of the SGP, credible enforcement of budget discipline might become a difficult task even in good times.

The problem inherent in both the old and the proposed SGP is that they have no mechanism to override national sovereignty. Taxing and spending decisions rightly rest with the elected representatives of each individual country, and since there seems to be no appetite for full political union, this is not going to change.

### **Three possible alternatives**

#### *Expulsion of a country from the euro area*

There are then only three possible ways of setting the right incentives for fiscal discipline. The first would be for the euro area to use the only credible threat available to any club: to revoke membership. The treaties could in principle be amended to specify conditions under which a country would be

automatically expelled from the euro area (Neumann 2010). However, this might be a too “Germano-centric” solution for the majority of countries.

What is more, some argue that there are at least two serious flaws in this idea (see Annunziata 2010). The first caveat is that the punishment might be “too harsh to be credible.” Expelling a country from the euro area would have serious impacts on the sinner and dramatic spillover effects on other members. “The second is that it would provide an ideal setting for speculation, the nemesis of European politicians. A country approaching the conditions for expulsion would quickly find itself under immense market pressure, as some investors would bet on its inability to redress the situation and others would need to hedge themselves against the potential consequences of its being kicked out” (Annunziata 2010).

One could argue that this misses the point because the fundamentals of Spain and Italy, especially in their self-financing capacities, appear much stronger than those of, for instance, Greece and Portugal. And this in itself speaks against the case that contagion might pull also Spain and Italy down. “Moreover, neither Spain nor Italy would gain much from a default since most of their public debt is held by their own citizens. A default would thus not lower the foreign debt of the country” (Gros 2010c). The litmus test for the euro area is thus not whether it is able to save a country like Greece, but instead whether it can protect members that do not suffer from insolvency from speculative attacks (Gros 2010c).

#### *Implementation of a European Monetary Fund*

A second solution would have been the immediate installment of a sovereign default mechanism such as a European Monetary Fund (EMF), i.e. the conversion of the starting capital provided by the European Stabilization Mechanism which currently is not more than a Special Purpose Vehicle into an EMF, which will be discussed in detail below.

*“Hard-coded” national fiscal limits*

A third potential solution would be to “hard-code” fiscal limits into each country’s legislation by means of automatic, binding, and unchangeable rules. Annunziata, for instance, advises euro-area policymakers to adopt the Polish procedure that enables the constitution to set a public debt ceiling. Every euro-area member country should be obliged to implement this clause in its own constitution as a condition-sine-qua-non for membership. Annunziata also proposes that any deletion or amendment of this clause should lead to an automatic exit from the euro area. A mechanism to override national sovereignty would no longer be necessary since each national legal framework would automatically preserve the common fiscal rules. By obeying the bottom-up decision pattern this would clearly serve the principle of democratic legitimacy. “It is hard to force a country to follow the policy dictates of its neighbor,” Annunziata argues, “but it should be much less controversial to argue that all members of the club should pledge allegiance to the commonly agreed rules in a fully binding way” (Annunziata 2010).

Such a solution though is politically demanding. But authors like Annunziata correctly state that the challenges justify politically courageous decisions. The euro area with its current institutional framework has sown the seeds of a larger moral hazard problem that will not be made obsolete by the conditionality connected with EU loans. One option for countries to cope with this problem is to internalize the euro area’s common objectives. As Annunziata puts it: “Requiring countries to amend their constitution sets the bar high – but it is the kind of step that would demonstrate near-irrevocable commitment to fiscal discipline, and the dividends in terms of credibility would be enormous” (Annunziata 2010).

In this sense, it would be a waste of time to continue with an SGP that is unenforceable (because it can never override national sovereignty) and time inconsistent (because when the time to tighten policy comes, countries have

no incentive to do so). The euro-area countries should commit to serious fiscal responsibility, the price to pay for remaining in or acceding to the euro area. This commitment could be made binding and effective by embedding the common fiscal rules within national legislation (Annunziata 2010). This institutional solution would of course not directly tackle the larger problem that is depressing the euro area and hampering convergence, namely the lack of progress in structural reforms. However, imposing binding limits on fiscal deficits would indirectly reinforce the governments' reform incentives since higher growth rates would render fiscal adjustment less painful (Annunziata 2010).

### **A postscript to the proposals**

With regard to economic policy, it was clear that the issue of different proposals for euro-area and non-euro-area countries would come up again sooner or later. Such a differentiation was emphasized in the position papers published by the Commission and the Franco-German finance ministers. They stressed sanctions and conditionality to a lesser extent for non-euro-area countries. Whereas leaving room for convergence might be a plausible initial argument in favor of this unequal treatment, the question looming is whether and by how much an economic "core Europe" could decouple itself from the non-euro-area countries and, by this, indirectly lower their probability to enter the euro area in the future.

As for the European Semester, the treatment and integration of national parliaments disposing of budgetary prerogatives is a critical issue. The national parliaments tend to insist on exercising their rights that makes a European peer review of draft budgets prior to the national budget process unlikely in the near future. This creates a constitutional problem that could not be solved by integrating the European Parliament. These problems

notwithstanding, the European Semester would even be useful for coordination by means of the exchange of information and creating transparency of information flows (Heinen 2010).

Finally, it would have been interesting to see whether and by how much market expectations would be impacted by quasi-automatic sanctions and a reversal of the burden of proof in the EDP. It cannot be excluded that the triggering of the EDP could have caused significant reactions by the markets. “On the other hand, such a change in processes of this kind – just like the European semester – would be a clear sign of a paradigm shift towards more serious budget coordination that could be rewarded by the markets” (Heinen 2010).

All three documents, the position papers by the Commission, the ECB, and the French-German study, referred to the objectives of the Europe 2020 growth agenda. On the one hand, this might give reason for some commentators “to hope that this growth agenda may be more successful than its predecessor” (Heinen 2010). On the other hand, it may only serve to contribute to “Europe’s competitiveness obsession,” a notion coined by Gros (2010a). He asks whether higher productivity is leading to higher competitiveness and is, thus, really the way out from intra-euro-area divergences. Across the European Union, even the opposite is true in many cases. For instance, Ireland, which experienced the highest growth in labor productivity at the same time, lost competitiveness to the largest extent. This is because improvements in productivity are easily overwhelmed by changes in wages.

The last part of the puzzle is to solve the central question of what determines wages. There is ample evidence that in the last ten years the largest wage increases took place in countries like Spain or Greece that experienced the strongest domestic demand growth. Thus demand drives wages and not the other way around. The PIGS suffered loss of competitiveness *after* unemployment in these countries had fallen sharply.

Their statistical loss of competitiveness thus should not be traced back to inadequate reforms or aggressive trade unions, but instead to booms in domestic demand. The latter has been driven above all by cheap credit for consumption purposes in the case of Greece and for construction work in the cases of Spain and Ireland. This, in turn, translated into higher labor demand and, as a consequence, also to higher wages (Gros 2010a).

If excessive domestic demand in the PIGS was the problem, the solution to intra-euro-area asymmetries should now be approaching. This is the other side of the coin of the purely market-driven equilibrating process. In this section we have shown that international investors already curtailed credit to the PIGS. The bold austerity programs launched in these countries should contribute further to lower growth rates of or, in some cases, even a sharp decrease in domestic demand there. “If labor markets are flexible, this should result in lower wages. Indeed, that is the key: labor-market flexibility on the way down as much as on the way up” (Gros 2010a).

“The proposition that governments ‘must do something about competitiveness’ risks leading to an excessively activist approach to economic policy coordination, with governments and EU institutions constantly trying to influence wage-setting in the private sector” (Gros 2010a). This activist approach has the potential to work at least partially in the current crisis. However, if domestic demand starts to diverge again, the same activist approach will not be able to prevent future divergences in competitiveness. Enacting structural reforms is useful in many cases. However, fostering productivity takes years and there is no guarantee that it really feeds into higher competitiveness. Instead, the southern European member countries must accept that domestic demand has to fall to a level that makes countries independent of protracted inflows of foreign capital (Gros 2010a). Once this threshold is passed, it should be enough to give labor markets sufficient leeway to approach and to settle at its new equilibrium.

## **Preliminary conclusions**

At the time of writing this paper, it was much too early to check whether the work of the task force would actually endow the European Union and EMU with robust convergence enhancing measures in times of larger uncertainty than usual. The outlook appeared mixed, if the proposals made by the van Rompuy task force were based on the published orientations and position papers, and not on the three alternatives presented in this section. Their main problem is that they are based on the fiction that the euro area is not allowed to lose even a single member. A European Monetary Fund (EMF) would eliminate the latter fiction and, simultaneously, be as market and incentive compatible as possible.

## **The European Monetary Fund: More pros than cons**

Gros and Mayer (2010a) argue quite convincingly that setting up an EMF to deal with euro-area member countries in financial difficulties is superior to either calling in the IMF or muddling through on the basis of ad hoc decisions. With respect to its financing mechanism, conditionality, enforcement, and the orderly default mechanism involving creditors as well, it does entail more limitations to moral hazard than other proposals. Gros and Mayer have suggested that this fund operate as an insurance scheme based not on euro-area country premiums, because the very existence of the EMF itself depresses Credit default swap (CDS) spreads and yield differentials within the euro area, but on the compliance of euro-area countries with the Maastricht deficit and debt levels (Gros and Mayer 2010a, 3). The less disciplined a country is in budgetary matters the more it would pay in. This might work much like an efficient preventive arm of the SGP.

Moreover, the ECB's 10 June 2010 position paper came up with similar positions without referring explicitly to the EMF. Most strikingly, the ECB proposals might also necessitate treaty changes, in the same way that the EMF does. This property, however, was used, for instance, by Angela Merkel as a knock-out criterion against the EMF (New York Times 2010). Actually, it is a subject of debate whether a treaty change would be needed to create an EMF or not. One might have thought that a legal opinion in its favor and a unanimous decision of the 27 heads of state and government would suffice. But also in this case one might ask what is wrong with installing an EMF when the ECB comes up with a rather similar proposal and the latter does not even emphasize any need of a treaty change.

Thus it was interesting to see what the position of the German government will finally be with respect to the ECB proposals. Without a clear framework, decisions about how to organize financial support typically have to be taken hurriedly, under extreme time pressure, and often during a weekend when the turmoil in financial markets has become unbearable.

The proposal by Gros and Mayer is not meant to constitute a "quick fix" for a specific case. Greece is the problem today, but it will not go away quickly. The experience of Argentina shows that default arises only after a period of several years in which economic and political difficulties interact and reinforce each other. Failure is not inevitable, as the relatively successful experience so far with tough adjustment programs in Ireland and Latvia shows. But what is unavoidable is a period of uncertainty. With an EMF, the Union would be much better prepared to face such difficult times.

But some countries, political leaders, and even the ECB have resisted the idea, raising concerns about having to bailout other EU countries due to their own reckless financial behavior. Others wonder whether an EMF is repetitive, overlapping with the IMF.

There are several arguments in favor of the view that installing an EMF is necessary beyond the role of the IMF. In the first place, an EMF creates a

global and a regional system (Johnson 2010). Other IMF-like regional funds that have been created outside the eurozone might serve as the blueprint for it (EU Business 2010). This would also deliver more symmetry in the distribution of funds worldwide. Another advantage is that installing an EMF avoids “foreign” IMF intervention, which might be strategically important in times of the euro area struggling for more impact in international organizations like the IMF or the G-20 (EU Business 2010). Any IMF bailout would undermine the European Union’s legitimacy.

As expressed by the German finance minister, the European Union needs an EMF with power equal to that of the IMF for the internal stability of the euro area (BBC 2010). Moreover, the EMF is specially designed for the euro bloc, whereas the IMF was not designed for developed euro countries (New Europe 2010). Thus, installing an EMF is neither reinventing the wheel with an already existing suitable tool, the IMF, nor is a potential EMF that can dispose of the special purpose vehicle (SPV) billions of funds not big enough to save entire EU countries. It does also not seem to be the case that the IMF has true neutral bargaining power. Even without saying that the IMF is U.S.-dominated and supports countries with U.S. military bases like, for instance, Greece, two facts stand out: 1) During the negotiations with Greece on the conditionality of the rescue package, the IMF proved less hardnosed than its two European counterparts in the “troika;” 2) One could be forgiven for thinking there is only limited U.S. interest in the stability success of the euro area because this would eventually mean the loss of the reserve currency in the long run (Belke and Schnabl 2009).

In terms of efficacy, the EMF would be able to improve EU fiscal federalism/coherence without incurring much of a moral hazard (Thoma 2010) and, even more important, would allow orderly sovereign default. It could impose tougher sanctions than the IMF (New York Times, 2010). The EMF could also enhance the transparency of public finances “because its

intervention mechanism in the case of failure would penalize all derivatives and other transactions that had not been previously registered with a special registry of public debt, which the EMF would maintain” (Gros and Mayer 2010a, 4). Just to state that the EMF is not a short-term solution to the immediate crisis does not make sense since the emergency measures already taken have opened a window of opportunity to install a long-run mechanism. The installment of an EMF is feasible because it could be financed effectively and would work much like the IMF, which stopped enormous bankruptcies in order to shore up the world economy.

A simple funding mechanism would also limit the moral hazard that potentially results from the creation of such a fund (Economist 2010b). Only those countries in breach of set limits on governments' debt stocks and annual deficits would have to contribute, giving them an incentive to keep their finances in order. This is exactly the reason that the EMF would not encourage fiscal irresponsibility.

In troubled times, however, the EMF would suffer from the drawback that is inherent in other solutions, such as the IMF solution, and the EFSF and its Special Purpose Vehicle. This drawback has, for example, been addressed by Perotti (2010) who argues referring to the Gros and Mayer proposal that: “(B)y the authors' calculations this facility would today give Greece access to something like .65 percent of its GDP ... plus any additional discretionary fund from the pool of all accumulated savings. However, .65 percent of GDP would make no difference to Greece today; and ... the intervention needed would eat up the whole fund just for a small country like Greece. The key problem country, Spain, with a public debt just above the Maastricht level this year, would have made virtually no contribution to the EMF. In the end, effective intervention, especially when the risk of contagion is high, is likely to depend on the discretion of Germany and other non-problem countries, just as it does now.” Moreover,

the availability of financial means should be no problem since the newly created Special Purpose Vehicle could be directly converted into an EMF.

As for public opinion, the EMF follows two distinct principles. First, solidarity around EMF would matter more than moral hazard. Member countries of the European Union have signed up to the principle of solidarity. Hence, they can expect to receive support when faced with extraordinary financing difficulties. And second, during financial crises when a member state is on the brink of collapsing, public opinion should matter less than coherent plans to address the crisis. The very fact that the EMF is funded proportionally to GDP might be unpopular among big states. However, alternative institutional solutions such as the hardening of the SGP still rely on budget deficits and debt levels per GDP. In any framework of orderly default, creditors should be involved according to their involvement and this is often proportional to their GDP.

This is not to say that the EMF idea has no drawbacks. One potential problem might be that if the EMF is stricter in terms of its conditions, European countries will go to the IMF. Moreover, much like other sovereign funds solutions the EMF might siphon off capital and increase national borrowing costs (Gokhale 2010). The recent events around a potential Greek default have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programs lack credibility and the balance sheet and the independence and reputation of the ECB is put at risk by the Securities Markets Program and huge additional exposure to the PIGS debt via the Emergency Liquidity Assistance (ELA) and normal refinancing operations (Belke 2010). One could even state that the euro area has by exactly this mechanism adopted the status of a transfer union. Only sovereign funds reveal the true opportunity costs to the initiators. However, if one chooses the way through the ECB and the printing press, the opportunity costs of adjustment programs wrongly appear to be close to zero. So, what is the problem in

making opportunity costs and the costs of a tacitly introduced transfer union explicit by increasing borrowing costs? The alternative would anyway, in view of our results, not be a separate hardening of the SGP but, instead, the introduction of something like constitutional national debt brakes or even a return to the paradigm of “let the market mechanism play.”

The latter solution is strikingly underrepresented in the array of public proposals of instruments to stabilize the euro, very much in the same way as representatives of the European System of Central Banks (ESCB) are nearly the only ones pointing at the strict orientation at the adjustment programs as the first best solution to rescue Greece. (Sinn 2010, section 3). Although all countries have announced broad-based bank rescue packages, investors have differentiated between countries mainly on the basis of other, more country-specific factors (e.g. the fiscal outlook). This pattern is usually revealed in a euro-area context by a comparison of ten-year government bond yield spreads of euro-area countries over Germany and the expected budget balance relative to Germany in a couple of studies mentioned regularly in ECB outlets. This has also been valid more recently since February 2010, when markets have increasingly differentiated among the weak members.

A policy implication of these findings is that market valuation of sovereign risk remains a valid mechanism to discipline fiscal policy, especially but not only in times of financial crisis. Therefore, some even argue there is little justification for the claim that governments faced with high risk premiums during the crisis deserve the solidarity of other governments in the euro area (Schuknecht, von Hagen, and Wolswijk 2010, and the papers cited in my June 2010 briefing paper for the European Parliament (Belke 2010, section 1). As stated above, the EMF does not go as far as this but maintains a conditional solidarity, i.e. countries in financial difficulties are entitled to financial support according to their previous

payments and their agreement to tailor-made adjustment programs supervised by the Commission and the Euro Group.

Another counterargument is that the EMF cannot be set up without a new treaty. The creation of the fund may indeed face legal impediments (EU Business 2010). German Chancellor Merkel says EU treaties, which currently forbid euro-area countries from coming to the financial rescue of another, must be changed. That could prove extremely laborious, going by the years of referendums and special exemptions required to ratify the Lisbon treaty. Countries like France have little appetite for new treaty negotiations. But if this knock out criterion is applicable to the EMF, this should also be the case for the ECB proposal as of June 10.

Finally, some argue that investing EMF assets abroad could cause consternation (Gokhale 2010). To ensure a credible commitment to crisis avoidance, the fund should be invested in non-European financial securities. But that would move investment away from Europe, something that member nations are unlikely to support. Further research should check the validity of these arguments and, in addition, whether they are relevant for the alternatives to the EMF, too. If the cons are weighted more heavily than the pros, and strictly enforcing budgets appears better than creating EMF, the solution must be to go for hard-coded national fiscal limits.

## **Conclusion**

Without the immediate installation of a sovereign default mechanism such as an EMF, the ECB would have to bear the burden. It would then risk becoming the “bad bank” of the euro area as timid investors would offload sovereign bonds with uncertain repayment values on the ECB’s balance sheet. The euro area would lose its most valuable asset, a highly reputed, price stability-oriented independent central bank. Investors understand that

some countries protected by the installment of the EFSF and the EFSM these days will still have the potential to become insolvent and are not limited to alleged illiquidity.

Recent events and proposals of "soft" debt restructuring have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programs and austerity packages risk lacking credibility and the SMP puts the balance sheet of the ECB at risk. What is more, only sovereign funds reveal the true opportunity costs to the initiators.

The most demanding task is to prevent the euro area from stumbling into a perpetuation of EFSF and the EFSM financial rescue packages since this could hinder the functioning of the markets. What is difficult to see at the moment is how, once started, it can stop. The preferred approach appeared to be the creation of an EMF. The European Stability Mechanism (ESM) agreed upon in March 2011 will be constructed in a way not significantly different than the EMF.

What is more, the ECB could contribute to sovereign debt consolidation by accepting (of course, after a transition period) solely bonds that are issued by those countries that have introduced upper bounds to debt levels as collateral. This proposal à la Martin Feldstein appears to be beneficial because imposing "debt brakes" and the resulting decrease in the interest to be paid should be in the national self-interest of the respective countries.

Convergence of interest rates within the euro area was also the result of rating agencies that avoided publishing stand-alone ratings of countries that would rightly exclude the difficult to quantify and politically biased convergence effects of sovereign bailouts. In terms of governance, rating agencies should be forced to proceed as it is now done in the case of the Deutsche Landesbanken for which the *Gewährträgerhaftung* has been abolished.

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## **Making Macroeconomic Stabilization Work: Lessons from the Crisis for the EU Budget Debate**

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When the great financial and economic crisis (GFEC from here on) hit the European Union in 2009, the debate over counter-cyclical budgetary policies was revived. National governments put together huge stimulus packages and the European Commission mobilized five billion euros for measures at the EU level, a historic first even if only on a small scale.

However, individual member states' stimulus measures lacked pan-European coordination. National governments unsurprisingly and quite legitimately designed the packages in such a way that most of the stimulus would be felt in their national constituencies, even if this meant reduced overall impact. Meanwhile, some countries such as Ireland and Spain quickly saw their stabilization attempts jeopardized by growing market pressure on their bond yields, forcing them to retreat quickly and move toward an austerity path. This made the downturn worse, which again is not surprising. At the moment, and to its discredit, the European Union has no means at its disposal to prevent such developments in the future.

Overall, the European countries' fiscal response clearly helped to overcome the GFEC. But this seems more a result of chance than design, and need not necessarily work again the same way in crises to come. Moreover, the same result could have been reached with fewer negative side effects. The debt crises in the eurozone's periphery and the increase of government debt would be less severe if funds had been used more

effectively and joint borrowing together with countries with lower debt levels had decreased borrowing costs.

In addition, in hindsight it turns out that fiscal policy could have done more in preventing the booms in Ireland and Spain prior to the GFEC, which led to the deep recessions these countries are now experiencing. Economic divergences in the euro area have played a large role in making the countries in the periphery vulnerable to a crisis, as some had long warned. Fiscal policy is a tool that could have prevented these divergences.

The consequences of the global economic crisis and the lessons learned from the European sovereign debt crisis necessitate a rethinking of fiscal stabilization mechanisms inside the European Monetary Union (EMU). In 2008 and 2009, the political debate concentrated on discretionary stabilization. Since then it has turned in the direction of a debate over “exit strategies” and fiscal consolidation through austerity measures. Academic analysis has interesting insights to offer on the potential of automatic stabilization, in particular for the eurozone.

This paper reviews the case for the introduction of automatic stabilizers in the EMU in view of the lessons learned from the European Union’s macroeconomic and sovereign debt crisis. It argues that since eurozone member states are unlikely to run a sufficient fiscal stabilization policy by themselves, a centrally organized fiscal stabilization mechanism is needed. We propose four measures to address this.

On the income side of the EU budget, one measure is new own resources that have a stabilizing function: a EU corporate tax or an EU income tax. As for the expenditure side, we propose, first, that the disbursement for investment spending should more closely match the business cycle by extending or speeding up the funding period. Structural funds could thus acquire a secondary purpose of stabilizing national or regional business cycles. The same principle could be applied to spending

redirected toward research and development, vocational training initiatives, and life-long learning.

Second, in order to facilitate the stabilization of the business cycle across regions and over time, the European Union should receive a mandate to build up reserves during economic upswings and spend then in downturns. This can be achieved without allowing the European Union to accumulate debt, if the system is introduced during a cyclical upswing. Such reserves could have complemented the five billion euros of discretionary spending by the Commission during the severe economic recession in 2008-2009. Thirdly, an explicit pillar of automatic stabilization should be introduced, namely a European unemployment insurance scheme to supplement the member states' national systems. Each country would still operate its own scheme, reflecting national preferences and traditions. Such a European scheme would not raise the overall contributions for employers and employees. It would only compensate for cyclical unemployment (and not for structural unemployment) as only those who have been regularly employed for a certain period prior to unemployment can receive payments.

### **Daydreaming about revamping the EU budget?**

The three proposed measures on the expenditure side would require financial resources that would initially be rather low. Nevertheless, political opposition will be strong. There could, however, be a window of opportunity. The debate on the future of the European Union's budget for the period after 2013, when the current financial framework runs out, coincides with an immense concern about the functioning of the eurozone. It is hence time to re-ask some obvious questions: Does automatic stabilization in the eurozone work sufficiently well? Is there a case to make for stabilization measures on the European Union rather than on the national level? In

particular after the GFEC, a growing number of experts is likely to answer “no” to the first, and “yes” to the second question.

A key argument in support of the measures we propose is that, in contrast to national attempts to stabilize economies discretionarily, they could provide partial stabilization without jeopardizing their primary purpose, i.e. bringing the economy closer to balance. Even if problems resulting from cyclical divergence in the eurozone would not all be immediately solved, a systematic change in the way the EU budget works would introduce an unprecedented European stabilizing function that could, in later years, be improved upon. Thus it is worthwhile engaging in this debate now for several reasons.

For one, the public and the political debate on the composition and volume of the next multi-annual EU budget (2014-2020) is going to gain pace in 2011 and 2012. It will most probably bear no major surprises. Member governments enter the negotiations with fixed variables. Some have set positions on the nature and volume of the policies that eat up the bulk of the budget, namely agricultural policy and structural and cohesion policies. Others have a very clear position with regard to their national contribution to the EU budget (e.g. the British refusal to give up its rebate or the net payers' position on the overall volume of the EU budget which in their view should not exceed 1 percent of the European Union's GDP). Nevertheless, the upcoming negotiations are a window of opportunity to push suggestions for further-reaching reform of the budget. Hence, the recent learnings on the role of fiscal policy for macroeconomic stabilization in the eurozone. It is not sufficiently recognized that a well-reformed EU budget with a stabilizing function would help to reduce the eurozone's governance problems.

This is all the more true as the eurozone is experiencing its deepest crisis and the most fundamental governance reform since the introduction of the euro. It is cynical to identify economic divergence – and not fiscal

indiscipline – as one of the drivers of the sovereign debt crisis that has pushed the euro to the brink of ruin and governments to adopt costly measures that can put out fires, such as the European Stabilization Mechanism, and not be willing to discuss how automatic fiscal stabilization on the eurozone level could help alleviate economic divergence in the future. The very mixed record of helping Greece, Ireland, and Portugal with loans in return for austerity and structural reforms should raise interest in the question of how to improve the prospects for a sound fiscal and growth environment for eurozone member states in the future.

Meanwhile, the political economy of structural reforms and the interaction between a positive macroeconomic environment and productivity growth are increasingly well understood. Studies highlight the importance of a stable macroeconomic environment for microeconomic policies (see e.g. Galí et al. 2005, Mabbett and Schelkle 2007, Aghion and Howitt 2006).

Furthermore, one of the key proposals in the current budget debate is the question of how to equip the European Union with own resources. Interestingly, many of the arguments made in favor of an EU tax miss a crucial point, namely its stabilizing effect. Taking this into account would considerably strengthen the argument for an EU corporate tax and, from an economic point of view, even a European income tax.

Lastly, the expenditure side of the EU budget must be reviewed. Politically, this will be very difficult as those member states that register high returns from agricultural or structural policies will try to obstruct far-reaching reform. But the key question of how the EU budget can be equipped with resources earmarked for stabilization functions needs to be asked some day in view of the indisputable importance of fiscal policy for a stable macroeconomic environment, in particular in a monetary union. Presently no expenditure is devoted to stabilization. Quite the contrary: previous expenditure has even had destabilizing effects in countries in which transfers from Brussels reached important volumes in terms of GDP ratios.

The resources are often spent without any consideration for the state of the national business cycle. In Spain, structural funds even expedited the construction boom and thus helped set the stage for the bust.

### **Reconsidering the importance of fiscal stabilization**

In recent years, not only policymakers rediscovered fiscal policy as a stabilization tool. Also among economists, fiscal stabilization policies are nowadays accepted more widely than a decade ago, supported both by demand side and supply side arguments.

The traditional theory of monetary integration has long argued that a monetary union with a centralized monetary policy also might need a stronger centralization of fiscal policy (see Baldwin and Wyplosz 2006). Handing over autonomy over monetary policy requires alternative adjustment mechanisms in the case of asymmetric shocks. If a high degree of labor mobility or wage flexibility cannot be attained, alternative mechanisms are necessary to bolster shocks. Fiscal policy can stabilize regional demand by increased expenditure, transfers or lower taxes. According to this argument, fiscal stabilization requirements in the EMU are actually bigger than in other federal entities as in the United States, as labor mobility in Europe is lower and wages are less flexible.

This argument was widely discussed in the early debate over how to structure economic governance for a monetary union.<sup>1</sup> But it fell into disregard as belief in the effectiveness of fiscal policy faded with the ascent of New Classical Economics in the late 1980s. Meanwhile, the political

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<sup>1</sup> See the special Reports and Studies issue no. 5/1993 of the European Economy. The issue was also raised before and during the Maastricht negotiations, e.g. by then Bundesbank President Hans Tietmeyer who insisted a currency union should be complemented by a political union.

realities of the early 1990s, notably the failure of the intergovernmental conference on political union, made more political integration with a larger budget unthinkable.

However, already in the years prior to the GFEC, the accepted view on this issue started to change. One central proposition of the New Classical Economists was “Ricardian equivalence,” the notion that an increase in budget deficits would be without effect as economic subjects would rationally expect higher taxes as payback in the future and would accordingly cut their private expenditure. Since then, considerable empirical evidence has emerged to support the argument that Ricardian equivalence does not hold in its absolute form (Riciutti 2003). In addition, extensions of modern micro-founded models have provided a new rationale for improving the effectiveness of fiscal policies. A number of models now show that fiscal stabilization policy can be effective if households are liquidity-constrained and have limited access to unsecured loans or if individuals use rules-of-thumb for their consumption decisions (see Andersen 2005).

Furthermore, economic research has come up with fundamentally new arguments for counter-cyclical fiscal policy. The internationally known monetary economists Jordi Galí, Peter Gertler, and David López-Salido find that business cycle fluctuations distort the efficiency of an economy if price rigidities or other market frictions exist, the cost of which can be quite substantial (Galí, Gertler, and López-Salido 2005). According to these scholars, major recessionary episodes in the United States have been related to welfare losses of up to 8 percent of annual consumption, a figure well above that quoted by Lucas (Lucas 2003) in his critique of stabilization policies. It might hence be “require[d] that appropriate fiscal and monetary policies are undertaken to guarantee that a higher level of activity is attained” (Galí 2005).

In a New Growth Theory framework, Harvard economist Philippe Aghion and his colleague Peter Howitt even argue that macroeconomic fluctuation

might hinder companies from conducting an optimum level of research and development, especially if financial markets are underdeveloped and firms may thus not be able to bridge periods of low earnings with fresh credit (Aghion and Howitt 2006). Since the benefits from stabilization policies grow with market imperfections in the approaches adopted by both Galí, Gertler, and López-Salido, and Aghion and Howitt, they provide arguments for more macroeconomic stabilization in the European Union than the United States.

In addition to these arguments, the momentum and strength of the GFEC threw into question a formerly powerful argument against fiscal policy. According to Classical and New Classical thinking, an economy is expected to self-correct quickly after a shock. Long recessions are unlikely. However, during the GFEC it looked as if some of the world's major economies would spiral ever deeper into crisis. Thus, discretionary fiscal policy was seen as a necessary instrument to stop the downward spiral.

### **The case for automatic stabilizers**

In principle, and especially in “normal” times without a major economic crisis, the use of automatic stabilizers seems to be preferable to discretionary policy (Andersen 2005). Discretionary fiscal stabilization policy involves long time lags from the initial economic slow down until a change in the policy stance actually leads to changes in output and employment. First, in order to enact appropriate expansionary policies, a macroeconomic shock needs to be detected early and the type of the shock analyzed accordingly. As most economic data is only available with a significant time lag (in most European countries, GDP data is published six weeks after the end of a quarter) and is subject to large volatility and revisions, there is a danger that fluctuations are only detected with a significant delay (detection lag). In addition, budgetary processes in most industrialized countries result

in a long lag between the first idea and the implementation of fiscal policy measures (decision lag). Finally, economic agents have to adjust to fiscal policy measures (such as tax cuts) and might take time to adjust their expenditure (policy lag). Automatic stabilizers get around this problem as their payouts are usually linked to some directly observable high-frequency data such as unemployment, and as they are automatic they are not subject to a decision lag.

Moreover, modern models hint that stabilization policy is most effective when it is limited to a short period of time (Andersen 2005). A permanent increase in deficits leads to an adjustment of the public sector toward the expected higher tax rates, while a temporary increase might just provide additional income to households, of which a share is liquidity-constrained. If fiscal policy is set in a discretionary manner, there might be reluctance to cut back public spending or increase taxes again even after the need for stabilization has ceased.

However, as we have seen since the onset of the GFEC, not all of these arguments necessarily apply for a dramatic crisis. In the event of a crisis of the GFEC's magnitude, the severity of the crisis might be quickly detected as one reason not to wait for final GDP data when major companies report a drop in their orders in magnitudes of 20 percent or more. Moreover, if the sense of urgency is large enough, national parliaments might pass emergency measures within days and administrations might start to disburse money within weeks. Thus, there is now a broad consensus that fiscal stabilization works best via automatic stabilizers in normal times, but that discretionary spending should and could be used in crisis times.

## **Stabilization Policy: The experience of the first years of EMU**

With no major economic crisis between the start of EMU and the onset of the GFEC, fiscal policy in the euro area was mostly confined to the use of automatic stabilizers. In principle, one would think that Western Europe's welfare states are well positioned to use their fiscal policy as a stabilizing tool. With a relatively high government-revenue-to-GDP ratio and a progressive tax system, as well as a generous social security system, automatic stabilizers should be strong. OECD economist Paul van den Noord finds in an analysis of tax and welfare systems that in most EMU countries, a change in GDP by 1 percent actually changes the general government's budget balance by 0.5 percent of GDP, compared to only 0.25 percent for the United States (Van den Noord 2000). In a simulation with the cyclical fluctuation of the 1990s, Van den Noord finds that these automatic stabilizers have erased roughly 25 percent of the fluctuations in GDP in the larger EMU countries.

However, as Van den Noord also notes, for the overall stabilization outcome it is important to look beyond automatic stabilizers. After all, it is possible for one country to manage to counteract cyclical fluctuations through a discretionary fiscal policy, even if automatic stabilizers are rather small. Similarly, it is possible for a government to counteract automatic stabilizers with a pro-cyclical discretionary fiscal policy, thus dampening or even eliminating their positive effects completely. This was exactly what some critics of the Stability and Growth Pact had warned: If countries with a budget deficit close to the limit of 3 percent of GDP were hit by a recession, they would be forced to cut back spending or increase taxes in the downturn, thus eliminating the stabilization effect exerted by automatic stabilizers.

We have found partial support for this claim (Dullien and Schwarzer 2009). While overall fiscal policy seems to have been acyclical since the

beginning of EMU, countries that have been subjected to the excessive deficit procedure show a different pattern. In the two countries that were first subject to this procedure, Germany and Portugal, discretionary fiscal policy turned strongly pro-cyclical after the introduction of the euro. In fact, in Germany, the Schröder government with its Hartz labor market reforms cut unemployment benefit duration and benefit levels for the long-term unemployed during this time, thus actively reducing the possible effect of the automatic stabilizers. In Portugal, the value added tax (VAT) was increased in a midst of an economic slump. It was found that the pro-cyclical effect of discretionary fiscal policy in EMU was so strong that it completely erased the positive stabilization effect of automatic stabilizers. These findings contrast to results in the United States and Japan where fiscal policy contributed significantly to economic stabilization.

If the time series were extended to the present, one would probably find similar results at least in the crisis countries Greece, Ireland, Portugal, and Spain. While at the beginning of the GFEC fiscal policies in these countries probably helped dampen the downturn, the austerity measures passed since spring 2010 have pro-cyclically amplified the recession. Here, discretionary cuts in public expenditure and discretionary tax increases have more than compensated for the working of automatic stabilizers.

### **Explaining Europe's failure to stabilize**

Against this background, the question arises why Europe fails to use fiscal policy to stabilize even though economic theory tells us that it has more need to do so than the United States. A possible explanation might be that national governments in the EMU that are responsible for stabilization policies might have reason to decide against them. As the British economist Charles Goodhart and his colleague Stephen Smith note, (Goodhart and

Smith 1993, 423) the smaller and the more open a country, the less incentive a government will have to use fiscal stabilization policies. If a country is very open, as is the case with the individual members of the single market, a large part of the stabilization effort can be expected to result in higher imports and thus beneficial effects for the trading partners, and not for the home economy. Thus, fiscal stabilization policy has positive external effects. The costs of stabilization policy in the form of higher government debt, however, have to be completely borne by the national government that undertakes it. If a single government weighs its own benefits from stabilization against its own costs for such a policy, it will rationally decide for a degree of stabilization, which is significantly lower than would be optimal for the currency union as a whole.<sup>2</sup> As stabilization policy thus has public goods character for a currency union, fiscal stabilization should take place on the highest possible level of government in a currency union.<sup>3</sup>

Another argument supporting this conclusion is the experience from the recent debt crisis in the euro area. The crisis countries Greece, Ireland, Portugal, and Spain have not by themselves been able to use their own fiscal policy for stabilization purposes, as the need for stabilization became too large in the recent crisis and the deficits needed for a meaningful stabilization would have pushed their debt levels and debt dynamics beyond the point of sustainability. In the case of Ireland and Spain this was the case even though the countries had run significant fiscal surpluses prior to the crisis. In these cases, moving stabilization policy to the European level

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<sup>2</sup> This is nothing else than the Nobel prize winner Paul Samuelson's (1954) seminal analysis that the private provision of goods with positive externalities leads to an underprovision of these goods.

<sup>3</sup> See the literature on fiscal federalism, as well as recently Collignon (2004), Begg (2005), Buti/Nava (2005) for their ways to integrate this argument in the current debate on budgetary policies in the European Union.

prevents countries from being forced to stop stabilizing the economy when they most need it.

### **Equipping the EU budget with an automatic stabilization function**

The EU budget was never conceived to have a stabilizing function. But against the background of these findings and the economic goals outlined in the preamble of the Treaty of the European Union, namely “to achieve the strengthening and the convergence of their economies” as well as “to promote economic and social progress for their peoples, taking into account the principle of sustainable development,” there is a case for a significant shift in the way the European Union both raises revenue as well as spends the money, especially under the conditions of a single currency. Of course, in particular in light of the GFEC, it is high time to rethink whether the way revenue is raised or the means of its dispersal can contribute to stabilizing business cycles in the monetary union.

### **The income side**

The European Union budget is currently funded through four kinds of “own resources”: agricultural levies, customs duties, value-added tax, and the GNP-based own resource that covers the difference between planned expenditure and the amount yielded from the other three resources. This latter source of finance contributes more than 50 percent of the revenues, as agricultural and other import duties have considerably decreased in the recent decades.

The question whether the European Union needs a new system of own resources has been up for debate since 2007 when the European Commission launched its consultation paper. From an economic point of view, this system better takes into account the wealth in the member countries than the current system does (and which is additionally distorted by various factors including the U.K. national rebate). This debate raged during the European Convention where France, Germany, Austria, Belgium, Luxemburg, and Portugal defined such a system as being in their interest.

Tax-based own resources are usually defended with the following arguments: increased transparency, increased EU autonomy, a more direct link to the citizen and more scrutiny of EU public finances, the need for an increased democratic legitimization, and justification of public expenditure in the European Union.<sup>4</sup> From the experience with the eurozone, we would add the cyclical stabilization function of a trans-European tax.

National budgets usually finance themselves from a combination of different taxes, some of which, such as capital gains taxes, progressive income taxes or profit taxes, are, cyclically, highly sensitive. If there is an unexpected shortfall of revenues, the gap is filled by increased government borrowing in most countries.

In principle, the VAT and the tariff part of EU revenue could work in a similar manner. But VAT and tariffs are among the least sensitive sources of revenue in cyclical terms, as consumption is relatively smooth over the business cycle. Moreover, any shortfall in VAT revenue is automatically filled via “own resources” that are extracted from the member states. This small effect is hence even completely counteracted by the current logic of the EU budget. Without the possibility of going into debt or at least drawing

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<sup>4</sup> One interesting contribution with references to the most important positions in the debate is Le Cacheux (2007).

upon reserves accumulated earlier, the EU budget cannot act as an overall stabilizer for the European business cycle.

### **The expenditure side**

The European Union's expenditure is currently concentrated on two major areas: the common agricultural policy (almost 680 billion euros) and structural and cohesion policies (308 billion euros). Together they constitute 70 percent of the 2007-2013 budgetary outline.<sup>5</sup> The bulk of EU public expenditure hence goes into redistribution, and large parts of the budget actually support the status quo and hinder change, as e.g. the expenditure for agriculture provides a permanent transfer to certain rural regions without bringing any advantages with regard to social or economic progress or development (see Becker 2007, Begg 1995, Buti and Nava 2003). Allocative expenditure is comparatively minor, totalling up to 74 billion euros for the Lisbon agenda (improvement of competitiveness), the financing of the European Union's citizenship policies and cooperation in justice and home affairs (10.7 billion euros), the European Union's international role (49.4 billion euros), and administrative costs of 49.8 billion euros.

There is currently no expenditure devoted to stabilization purposes. The structure of the EU budget as such prevents any money flowing into automatic macroeconomic stabilization. The main reasons are the structure of the income and the expenditure sides and the organization of the EU budget process in six-year programs, which leave no room for reaction to cyclical developments. All expenditure is distributed or allocated to multi-annual programs that follow objectives other than cyclical stabilization (e.g.

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<sup>5</sup> The figures are taken from the inter-institutional agreement with the European Parliament of 4 April 2006 which is based on the Council decision of 17 December 2005.

redistribution to underdeveloped regions or uncompetitive market segments, allocation of means to create infrastructure, to finance research, etc.).

Looking at each individual country, the situation is even worse because for some of the countries transfers from Brussels are much more important relative to GDP and affect a much smaller sector of the economy than the revenue side. For example, structural funds alone amounted on average to almost 10 billion euros for Spain annually in the years 2000 to 2006 (more than 1 percent of GDP), with most of this money going into an already overheated construction sector, the excessive size of which has been considered to be one of the main reasons for the deep crisis of the Spanish economy. One problem is that the money is spent at a predetermined speed without any consideration for the state of the national business cycle. Thus, structural funds can amplify a national boom and then expire exactly the moment the economy slumps.

In order to solve these problems, one could condition the speed of disbursement for investment-spending around the position of the business cycle. Work on planned infrastructure projects would be delayed when the national economy in question is growing above trend and expedited when growth falls below trend. The idea is not to suddenly reduce funding without prior notice, but rather to extend or speed up the funding period if need be. In most cases, this should be a measure appreciated by the contractors in the projects (and could even be negotiated in agreement with them). In a period of overheating in the construction sector, contractors may be happy to delay certain projects to a time when their order books are less packed and they have spare capacities to do the job. An alternative would be to vary national co-payments according to the cyclical condition of the economy (yet, again, not altering the overall amount of money the country receives, but only to time span in which the sum is paid out).

Without additional costs, the existing structural funds could thus be brought to a secondary use of stabilizing national business cycles. This

principle could also be applied when some of the expenditure is shifted from traditional cohesion and structural fund expenditure toward areas that are more compatible with the Lisbon agenda, such as research and development or higher education, with higher disbursement in times of economic slump and lower disbursement in times of rapid growth. While for the capital expenditure part of research and development (construction of laboratories or buildings) the mechanism described above could be applied, for large parts of research and development such as the hiring of personnel, one would need a different approach as it is not feasible to delay a project once it has started. One possibility would be to start certain subsidized research and development projects at the beginning of a downturn when unemployment also among scientists and engineers is rising.

A shift toward a more cyclically sensitive tax than the VAT would likewise improve its stabilization properties (see Dullien 2011). A progressive personal income tax would probably provide the best stabilization properties (Goodhart and Smith 1993). However, introducing such a tax on the European level would be extremely complicated given the huge differences in national preferences and tax bases for personal income taxes, as well as for reasons of political acceptability. An EU corporate tax seems to be the second best solution. A common EU corporate tax would not only be a more cyclical revenue source. This would in addition allow for the introduction of a minimum level of taxation, which has recently become a pressing concern for some member states in the course of providing emergency help for the illiquid, low-income-tax country of Ireland. As is the case with the federal states in the United States, introducing an EU corporate tax would limit the excess of harmful tax competition while it would not impair the single countries' power to levy an additional corporate tax on profits in their jurisdiction, thus still allowing for a certain degree of tax competition.

In principle, the whole EU budget beyond the revenue from tariffs could be financed with a Union-wide corporate income tax without increasing the overall tax burden for corporations: In all single EU countries, taxes on corporate income exceeded 2.2 percent in 2007 and 1.9 percent in 2008 (see OECD 2010, 85). The whole EU budget of 1.27 percent of GDP could thus be financed by a common corporate tax leaving all countries ample room for an additional national corporate income tax. Shifting taxation to this new source would be neutral for national budgets as well as for taxpayers. Since the European Union would be financed with corporate income taxes, the revenue now allocated to the EU budget from VAT and the national budgets would be available for national expenditure, allowing the countries to lower their own corporate income taxes by the amount of the new EU-wide tax. In order to allow for the stabilization of the business cycle not only across regions, but also across time, the European Union would need to be allowed to build up reserves in an economic upswing and draw down on them in a downswing.

### **Introducing an explicit pillar for stabilization in the eurozone**

Finally, in order to reach a stabilization closer to those of other advanced countries, an explicit pillar for stabilization policies in the European Union would be desirable. In the early 1990s, there was a lively debate on possible stabilization schemes (Goodhart and Smith 1993; Majocchi and Rey 1993; Italianer and Vanheukelen 1993; Pisani-Ferry, Italianer, and Lescure 1993). More recently, Roland Deiner (Deiner 2004), Dullien and Schwarzer (2005, 2006) and Mark Nevin (Nevin 2007) have picked up the argument. The most interesting result from this discussion has been that expenditure need not be large in order to provide significant effects. According to Italianer and Vanheukelen, a fourth of all country-specific GDP

fluctuation could have been stabilized with an average cost of only 0.2 percent of GDP. In their model, single countries would be paid a variable amount should national unemployment rise significantly faster than unemployment in the rest of the Union.

However, these proposals do not address the political economy problems of stabilization policies in very open economies, such as those in the eurozone. Even if national governments were given money in a downturn, it is not clear whether they would use it right away for expenditure increases or tax cuts. In particular, countries constrained by very high deficits might use the additional funds for budget consolidation to have room for additional spending or tax cuts just before the next elections, which would not stabilize the cycle.

An alternative solution would be the introduction of basic European unemployment insurance. For all employees in participating countries, a certain payroll tax (back-of-the-envelope calculations estimate that roughly 2 percent would suffice) on wages paid up to a certain limit (possibly the national median wage) would be collected. From this money, employees who have paid contributions for more than a year would be allowed to draw benefits of half their last salary up to a limit (possibly half the median wage) for a period of six to twelve months. This basic unemployment insurance would replace only part of the national system. Each nation would still have its own national unemployment insurance that would reflect the national choice for social security as it would top up the payments from Europe (either in the monthly benefit amount or in the duration of benefits), without raising the overall burden on employers and employees and without threatening to eliminate national specificities as national governments would still define the level and duration of benefits and bear the costs for very ambitious schemes.

Such a system would fit very nicely with existing unemployment insurance schemes, as all eurozone countries (with the exception of Ireland

and Greece) have unemployment insurance systems that are financed by payroll taxes and that pay benefits relative to past earnings. By retaining the overall benefits paid to the single unemployed, changing its source of funding alone, there would be no deterioration in the incentives to look for new work.

Such a scheme would stabilize the business cycle by draining purchasing power from countries in which the economy booms as unemployment in these countries falls. If a country goes into crisis, purchasing power and thus domestic demand would automatically be shored up. By funnelling the money directly to the unemployed, it is guaranteed that the money is actually spent. The system would only explicitly compensate for cyclical unemployment and not therefore for structural unemployment as only those who have been regularly employed for a certain period prior to unemployment can receive payments. Short-term unemployment is an excellent indicator for the output gap. Those who have recently become unemployed are by definition the unused potential of the national economy in question. In addition, by reacting to unemployment, the mechanism would not induce transfers caused by quarter-to-quarter fluctuations in GDP growth figures, but only if an economy experiences a protracted upturn or downturn of the kind that could be expected to impact the long-term growth path.

The overall amount of money required to achieve meaningful stabilization effects via unemployment insurance need not be large. According to the American economist Lawrence Chimerine and his colleagues, U.S. unemployment insurance has roughly stabilized 15 percent of fluctuations in GDP, even though it only moves about 0.4 percent of GDP each year (Chimerine et al. 1999).

## **Conclusions and outlook**

While the proposed measures may read like a quantum leap forward toward a better EU budget, there is a caveat. The proposed measures only use instruments designed for purposes different than macroeconomic stabilization, such as productivity enhancement for the case of research, development and infrastructure expenditure, poverty alleviation for the case of the unemployment insurance. Stabilization of the business cycle hence may not be perfect. But nevertheless a huge profit can be expected.. This approach would allow for partial stabilization without jeopardizing their primary purpose, bringing the economy closer to its optimum.

Recent crisis experience has shown that the need for a common stabilization policy is larger inside eurozone than for the rest of European Union since the eurozone countries can no longer use national monetary policies. In addition, the current process of economic governance reform leads to a governance set up that distinguishes the specific needs in the EMU more clearly. With regard to new instruments for automatic stabilization, also eurozone-only options should be explored. For instance, the basic unemployment insurance could only be set up for eurozone members (or even only part of them), with an option for other countries to join. This would be politically more feasible than trying to get all EU members to agree to such a scheme.

The introduction of an EU tax would meanwhile only be possible for all EU members and it would raise the procedural requirements to decide on a democratically legitimate EU budget. Today, the main source of legitimacy runs through the national governments. As the benefits of EU integration and of the policies financed through the EU budget are (at least for the net contributors) difficult to justify vis-à-vis their own electorate, the basis of legitimacy for the current EU budget is comparatively low.

Even if the budget as such was not fundamentally changed, budgetary compromise in the EU-27 is extremely difficult as the negotiations of the financial framework 2007-2013 has shown, resulting not only from the sheer number of negotiators but also from the heterogeneity of their preferences. The lack of trans-European legitimating mechanisms provides a bias against reasoning in terms of European public goods. Collective action problems and temptations for free-riding prevent coherent action with the European Union's resources. Logrolling is a problem in this context as member states are more likely to find a compromise if they trade different policies and financial flows against each other (Collignon 2003).

Meanwhile, the "no-taxation-without-representation" rule remains valid for the European Union: if EU taxes are raised, their imposition has to be based on a democratically fully legitimate and transparent process that gives voters the chance to sanction those who have imposed the taxes, and give newly elected majorities the chance to change the direction of socio-economic policies reflected both in income and expenditure side of the EU budget.

Assuming that the guiding principle of any future EU budgetary system should be the added value generated in terms of European public goods by EU expenditure, our proposals are in line with political economy considerations of national governments' incentives. Their implementation would not only improve the functioning of the EMU, but would also be a quantum leap in EU budgetary policy and in integration as such, given the need for democratic legitimacy of the new mechanism.

Our starting point was the analysis of the new efficiency requirements that budgetary policies have to meet in the field of stabilization – and which they don't under the current design of the EMU. During the GFEC, economic tensions and imbalances in EMU, which had grown for years, resulted in a deep recession and a debt crisis in the euro area's periphery. If similar crises are to be prevented, macroeconomic fluctuations and boom

and bust cycles need to be better brought under control. Both problems could be mitigated by a more intelligent use of funds. Combining a relocation of expenditure toward productivity-enhancing goals such as research and development with stability-enhancing revenue and spending and an additional explicit stabilization pillar in European Union finances could provide a triple benefit. As the solutions proposed in this article are aimed at providing additional stabilization without reducing the funds' impact on productivity, productivity growth could be boosted making the European Union more competitive. The economic workings of the eurozone would thus be improved. Finally, if this works, it would even prevent the calls for permanent transfers from rich to poor countries, strengthening the political support for and reducing the risk of political backlash against European integration.

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## What the Think Tanks are Thinking

*Álvaro Aguillo Fidalgo\**

In 2010 and early 2011, Europe's think tanks and research centers devoted considerable resources to comment on both the political management of the economic crisis and the policy debates that derived from it, including on the reform of European economic governance. As the international economist Alessandro Leipold of the Lisbon Council think tank notes in an article reviewed below: "A single issue is dominating European-level deliberations, and deservedly so. The issue is European Union economic governance – that is, how to equip Europe with rules, procedures, and institutions capable of ensuring the sustainable functioning of economic and monetary union for the indefinite future." As Leipold rightly argues, "The related stakes are high – indeed, no less than the future of the euro itself hangs in the balance."

The Brussels-based, economic think tank **Bruegel** actively monitored the effects of the crisis. In February 2011 in a policy paper entitled "A European Fund for Economic Revival in Crisis Countries," the Italian economist Benedicta Marzinotto looks at the available cohesion and structural funds for some EU countries, and suggests that these should be used to compensate the recessionary impact of fiscal consolidation and to preserve essential investment. "Significant volumes of Structural and Cohesion Funds have been pre-allocated but remain undispensed or uncommitted," she writes. "These funds should be part of a temporary

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European Fund for Economic Revival for 2011-13, which would promote economic growth in crisis-hit countries and facilitate structural reforms.” Instruments of economic stimulation should be strengthened in the frame of the European Fund for Economic Revival, she argues, and synergies between EU grants and European Investment Bank loans should be supported. “EU funds should turn into a booster fund for economic revival in crisis countries,” she concludes.

In the February 2011 policy brief “A Comprehensive Approach to the Euro-Area Debt Crisis,” Zsolt Darvas, a Hungarian economist who teaches economics at Budapest’s Corvinus University; André Sapir, a Belgian economist and professor of Economics at the Université Libre de Bruxelles; and Jean Pisani-Ferry, a French professor at the Université Paris-Dauphine and director of Breugel, argue that “EU policies have been insufficient to solve the problem for three reasons: they have failed to recognize the possibility of insolvency and have addressed all crises as if they were pure liquidity crises; they have failed to address systemically the interdependence between banking and sovereign crises and cross-country interdependence; and they have been reactive rather than proactive, squandering credibility because of inadequate responses.” They propose an all-inclusive solution to the current European crisis based on three pillars: a plan to restore banking sector reliability; a resolution of sovereign debt crises (including a reduction of the Greek public debt); and a strategy to foster growth and competitiveness, with particular emphasis on the differences between the countries in the periphery.

Nicolás Verón, a French consultant, published “European Bank Stress Tests: Third Time Lucky” in December 2010. In it, he illustrates the problematic nature of crossborder interdependencies that force the eurozone to restructure whenever one member is facing macroeconomic troubles. “Policy paralysis throughout 2009 and 2010,” he argues, “has resulted in a banking system precariousness that puts a serious drag on the

old continent's recovery. An even more dramatic consequence is to force the eurozone to systematically choose bail-outs over restructurings, whenever one of its members faces macroeconomic difficulties." He argues that a government-led process of triage, recapitalization, and restructuring of the system is needed, as banking crises are almost never self-correcting.

In another text published that same month, "EU Financial Regulatory Reform: A Status Report," Verón explains why EU regulatory responses are slower than U.S. ones: "swifter financial crisis management and resolution in the US; structural differences in legislative processes; the European Union's front-loading of institutional reform, most notably the creation of European Supervisory Authorities; and the timetable of renewal of the European Commission in 2009-10." He spells out the consequences of the current EU financial reforms and highlights some major challenges: ensuring a smooth start of recently created EU authorities; defining a credible policy for sustainable crossborder management; and establishing a consistent EU model of financial regulation.

Daniel Gros, a German economist from the Brussels-based think tank **Centre for European Policy Studies (CEPS)**, commented on the Eurobonds option in "Europe's Futile Search for Cheaper Money" in February 2011. He argues that the positive effects of the Eurobonds on interest rates, liquidity, and for reducing debt could turn out to be more limited than expected. He concludes: "The key insight of the dismal science bears repeating: there is no free lunch. What debtor countries gain in terms of lower financing costs would be offset by the losses for creditor countries both in terms of higher borrowing costs and lower interest income." In "Debt Reduction without Default," also in February 2011, Gros and Thomas Mayer, an economist at the Deutsche Bank, a German global financial service company, propose a two-step market-based approach to reduce debt in which the European Financial Stability Facility would acquire debt, easing pressure on the individually affected countries, and then assess debt

sustainability country by country. They conclude: "In this longer-term perspective, we regard our proposal as a key step to establishing the principle that losses on sovereign lending are possible. It is extremely important that markets and regulators actually have the experience of suffering some loss as this is the only way to ensure more market discipline [...] in the future and a regulatory framework that abandons the concept that sovereign lending is riskless."

In November and December 2010, Janis A. Emmanouilidis, a political analyst and consultant at the **European Policy Centre**, a think tank based in Brussels, commented on the European Council meetings in October and December in two articles: "The Bumpy Road to Economic Union" and "Adding Pieces to the European Economic Governance Puzzle." Emmanouilidis raises a series of doubts regarding the necessity of changing EU treaties, particularly the amendments agreed upon at the referred summits. He is skeptical about the Stability and Growth Pact, particularly in regard to the European Stability Mechanism. "There are still many uncertainties and open questions related in particular to the establishment of a new permanent crisis mechanism and the 'necessity' of changing EU Treaties," he argues.

From the **Stiftung Wissenschaft und Politik** (German Institute for International and Security Affairs), a think tank based in Berlin, Ognian N. Hishov in "Die implizite öffentliche Schuld" ("The Implicit Public Debt") examines the problem of the debt that derives from future welfare expenses that EU countries will have incurred.. The German political scientist describes how this could influence overall economic governance within the Union and considers that the Commission should include the implicit debt on the Excessive Deficit Procedure.

A study conducted by Daniela Schwarzer, a German political scientist, and Sebastian Dullien, a German economist and journalist, entitled "Exposure to the Governments' Money in the Eurozone" (July 2010),

presents recommendations on how to reduce moral-hazard problems, which arise when “tied-aid credits are given too easily to single countries, particularly combined with the new policy of the European Central Bank: buying government bonds.” They recommend establishing a permanent liquidity fund, implementing an insolvency law for euro-countries, and adopting community bonds for a maximum of 60 percent of overall government debt.

In the 10th Report on the European Economy (February 2011), the **European Economic Advisory Group** focused on European public debt. A series of recommendations are given in order to redesign the governance system. A three-stage crisis mechanism is proposed based on the European Stability Mechanism: liquidity support, a plan in case of impending insolvency, full insolvency procedure. “A common theme underlying our discussion,” it writes, “is the role that the euro has had on European imbalances in trade and capital flows. While we consider the euro a useful and necessary integration project for Europe, we believe that in the absence of an appropriate economic governance system it has contributed to the problems currently affecting Europe.” The situation in Greece and Spain are analyzed and a chapter is dedicated to the supervision and taxation of the banking sector.

The **Real Instituto Elcano**, a Spanish think tank, provides broad coverage of the reform of economic governance in Europe. In “The Negotiation for the EU’s Multiannual Financial Framework: A Balance between Need and Economic and Political Limits” (November 2010), Mario Kölling, a Spanish lawyer and researcher at the Universidad de Zaragoza, analyzes the Commission’s October communication on the revision of the budget and prospects for the development of the negotiations ahead given the current economic context. Two different outcomes are possible: either a new path in the development of the budget is found or negotiations remain indifferent to the current spirit of reform so that the multiannual framework

remains similar to previous ones. Kölling concludes that "regardless of the answer [to this dilemma], several tense months of debate are to be expected, throughout which mathematical calculations of net balances will prevail over the spirit of unity that helped to set the ambitious goals of the 2020 strategy."

Carlos Buhigas Schubert, a Spanish independent analyst and consultant, and András Inotai, a Hungarian economic expert, in "The German Dilemma: Between Leadership and Reluctance" (March 2011) and Luis Martí, a Spanish economist, in "Rebuilding the Euroarea: Germany's Role" (February 2011), scrutinize Germany's stance on the reform of the euro area. "It is not possible to maintain the integrity of the eurozone without the active involvement of its most powerful country: Germany," Martí writes. "The German authorities were supporters of this framework and are currently leading the initiative to propose new internal pacts that ensure the definitive financial solidity of the eurozone. There is intense debate, both inside Germany itself and in other member states, since the process involves bringing together very different political positions." He explores the consequences Germany's reform measures could have for the future of the Union. The study also reviews the regulatory and operating framework originally imposed by the European Economic and Monetary Union on its members and the main reason why it failed to prevent the recent national crises.

In "The Euro War that Won't Happen," Juan Crespo, a Spanish statistician, argues that the current crisis has had positive consequences for European institution-building as it has led to more integration. Therefore, although the crisis will endure, he sees no risk for the integrity of the euro. He concludes: "The difficulties of the year 2010 have been a nightmare for eurozone countries. Unless a miracle occurs, the incorrectly named crisis of the euro might become a blessing that has enabled us to get ready to face

more difficult times. In fact, it would have only been the rehearsal of something much more complicated yet to come.”

**The Policy Network**, a London-based think tank, following up a February 2011 symposium entitled "What Future for Europe?", produced a publication under the same title in which experts analyzed the current state of U.K.-EU relations. “In the immediate future,” it argues, “the European Union faces major challenges in securing the economic recovery, managing the sovereign debt crisis in the eurozone, and limiting the damaging consequences for Europe’s crossborder banking system and its wider economy. The United Kingdom must not remain a bystander in this debate but should be guided by a greater understanding of the choices available to it – and indeed to the Union itself.” Deeper integration in the European Union is necessary, it concludes, and the United Kingdom should rethink its approach toward the Union in order to profit more. For that to happen it is necessary to have a closer look at the overall evolution of economic governance in the European Union.

**The Lisbon Council**, a think tank in Brussels, contributed to the debate with the paper "Good Governance for the Euro Area: Proposals for Economic Stability" (August 2010) by Alessandro Leibold, an international economist. Leibold points out the absence of mechanisms to secure financial stability, the over-reliance on sanctions, and the delayed work on crisis management. “The crisis – and notably the European Union’s difficulties in dealing with the Greek situation – has undeniably focused minds,” he writes, “leading to a comprehensive definition of the objectives, procedures, and instruments required for the European Union’s effective economic governance. [...] But there remain critical gaps in the proposals that need to be addressed before decisions are finalized in the remainder of the year.” He suggests a nine-step program to overcome these problems and argues that current reforms are not sufficient to ensure a functioning economic and monetary union.

"The 2010 Euro Monitor: Indicators for Balanced Growth", a study carried out jointly by the Lisbon Council and Allianz, a German financial services provider, underscored highly comprehensive indicators for balanced growth. Using detailed figures it evaluates euro-area members' comparative strengths in fiscal sustainability; competitiveness and domestic demands; jobs productivity and resource efficiency; and private and foreign debt. As the study argues: "The Euro Monitor enables us to evaluate the extent to which an EMU country is achieving balanced macroeconomic growth and hence contributing to a stable development of the eurozone economy and its currency. In a very differentiated manner, with the help of four categories comprising 15 indicators, we can keep track of what kind of risks or opportunities the country-specific fundamentals pose for the eurozone as a whole." It notes that the Euro Monitor would have indicated prior to the sovereign debt crisis that "peripheral countries such as Greece and Ireland had lost track of their balanced growth paths." The study believes that the Euro Monitor has merit as "an early warning tool. In 2008, an alarming 8 out of 15 indicators for both Greece and Spain were flashing red, highlighting the macroeconomic risks," it concludes.

In an October 2010 essay entitled "Why Germany is not a Model for the Eurozone," Philip Whyte, an economics expert at the **Centre for European Reform**, a think tank in London, argued that the current German model would not be suitable for the whole euro area: "Turning the eurozone into a larger Germany would have adverse consequences – not just for Germany itself, but for Europe and the rest of the world. Europeans cannot pretend that the world economy can rebalance without parallel rebalancing in the eurozone." Replicating this model would carry internal and external pernicious consequences, causing yet more asymmetries. Germany also has to conduct reforms. If the periphery is to become more German, then Germans will have to become less so. Indeed, Whyte concludes that "some countries, notably in the eurozone's indebted periphery, could do with a

dose of German sobriety. But an unreformed Germany would be a poor model for the eurozone as a whole. Germany is not the 'world-beating' economy of current legend. It, too, needs to change."

Simon Tilford, a political economy analyst, in "How to Save the Euro" (September 2010) underscores the importance of achieving greater economic and political integration to save the single currency. "Unless there is a rethink," he argues, "the eurozone risks permanent crisis, with chronically weak economic growth across the region as a whole, and politically destabilizing deflation in the struggling member states. This would create strains between the north and south of the eurozone and between France and Germany, in the process damaging the chances of progress in other areas of EU business." Poor economic prospects and imperfect integration call for a deepening of the single market, an improvement of coordination mechanisms, a recapitalization of banks, and a strengthening of the fiscal union.

In its April 2010 Monitoring Report, the **Institute of World Economics**, a Hungarian research center, examined the political, social, and macroeconomic landscape of those countries that became part of the Union in 2004 and 2007. "The financial and economic crisis hitting Europe since the autumn of 2008 has checked the favorable trends observable in the new member states since 2004 and has its impact up to now," it argues. Yet there is a remarkable level of heterogeneity in terms of growth perspectives and the measures undertaken to tackle the effects of the crisis, it argues. It points out the increasingly important role that these new members are playing in the Union's decision-making processes. Job creation and consolidation of public finances are key to a return to growth, it concludes: "Even if the most optimistic perspectives are taken into consideration, the recovery from the crisis seems to be a slow process in the European Union. In each of the ten member states examined in this report, the return to sustainable growth has to be accompanied by job creation and the

consolidation of public finances in order to continue the process of catching up to the old EU member states.”

A December 2010 text by representatives of the **Trans European Policy Studies Association**, a trans-European research network, was presented to the Hungarian presidency with a series of recommendations under the title "Priorities and Challenges of the Hungarian EU Presidency." Regarding economic governance, the text examined the particular importance of the Hungarian presidency during which crucial reforms will be implemented: "A top priority of the Hungarian presidency should be to see to it that the newly established permanent crisis mechanism will be designed in such a way as to facilitate enhancing European competitiveness and prevent future crises.”

For the **Istituto Affari Internazionali**, a Rome-based think tank, Luigi Gianniti, an Italian lawyer and professor at the Università degli Studi Roma Tre, analyzed in "Il meccanismo di stabilità e la revisione semplificata del Trattato di Lisbona: un'ipoteca tedesca sul processo di integrazione?" (February 2011) the problematic nature of building into the treaty a permanent mechanism to safeguard the stability of the eurozone. The German Federal Constitutional Court has set a precedent "which may make it harder to appeal to the clause of flexibility in order to advance European integration."

**Notre Europe**, an independent think tank based in Paris, was also very active analyzing the management and impact of the crisis. In the February 2011 policy brief, "The European Semester: Only a First Step," Jacques Delors, a French economist and politician; Sofia Fernandes, a Portuguese economist; and Emmanuel Mermer, an economic governance expert, tackled the European Semester initiative. The idea, they argue, is aimed to correct structural problems, particularly gaps in competitiveness, and improve macroeconomic and budgetary surveillance. This should lead to better communitarian synchronization. "The European Semester represents

a step forward in European economic governance. It is nonetheless insufficient if the EMU is to have the economic pillar it needs," they argue. They identify problematic elements: a straddling between the EU-17 and the EU-27, too much reliance on sanctions, too little attention to growth in favor of financial stability and an insufficient involvement of third actors.

The July 2010 study "Where is Germany Heading," directed by Renaud Dehousse, a French lawyer and professor at Sciences Po, and political scientist Elvire Fabry includes contributions from several researchers. It analyzes the current German stance toward the eurozone. Berlin, they argue, is assuming a leadership role that it is still a bit uncomfortable with: "No European country has ever consented to as big a transfer of sovereignty as Germany did when it accepted to do away with the Deutsche Mark. That, in and of itself, is sufficient to explain why she [Merkel] has found it difficult to tolerate the unruly behavior of other eurozone members." In this light, they examine factors that could explain its recent European policy and conclude: "The fact remains that Germany now finds itself in a leadership position that it has not sought, and that it seems at times reluctant to exert."

Notre Europe also issued "The Contribution of 14 European Think Tanks to the Spanish, Belgian, and Hungarian Trio Presidency of the European Union" in March 2010. One chapter, Daniela Schwarzer's "Governing the Eurozone out of the Crisis," looks at economic governance, analyzing some of the challenges for the expiring trio presidency. Particular attention is paid to the necessity of defining clear exit strategies. Therefore, clear political priorities have to be set, coordination improved, and more attention must be given to all relevant players while clarifying the governance structure. As she puts it: "Strong political commitment and a strengthening of the authority of all actors involved in economic-policy coordination would help the EMU and the European Union to act more swiftly in a new round of the crisis. The European Union under the trio must prepare for new cases of

crisis management which may be more complex to solve than many of the incidents since 2007.”

In "New Changes and Old Challenges in the Economic Governance of the Eurozone," the Spanish state economist Clara Crespo calls for more visible and clear leadership given the complex matrix of external representation regarding economic governance. Furthermore, she argues that it would be rational to revise the membership conditions for a further enlargement of the euro area, as the current convergence criterion has lost relevance from an economic point of view. "The three pillars of economic policy in the eurozone," she argues, "once again change in dimension: monetary policy emerges strengthened, the goals of fiscal policy change, and questions arise over whether the crisis will serve as a lesson to encourage structural reforms. But the biggest change is that the crisis has given more relevance to other aspects of eurozone governance, such as its enlargement and its external representation."

The **Institut für Europäische Politik**, a German research center, together with the **Otto Wolff Stiftung**, a Cologne-based foundation and the **Centre International de formation européenne**, a private French international association, put together opinions from various think tanks and other institutions from 31 European countries, some of which have been mentioned above. This last report focuses mainly on the implementation of the Lisbon treaty; enlargement and neighborhood policy; and climate and energy. An entire chapter is dedicated to European economic policy and the financial and economic crisis. In this chapter, an array of international researchers issued comments for almost every European country.

## Abbreviations

BoP	Balance of payments
CAP	Common Agricultural Policy
CDS	Credit default swap
CEPS	Centre for European Policy Studies
CSR	Country-specific recommendations
DIW	Deutsches Institut für Wirtschaftsforschung / German Institute for Economic Research
ECB	European Central Bank
EDP	Excessive deficit procedure
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIP	Excessive imbalance procedure
ELA	Emergency Liquidity Assistance
EMF	European Monetary Fund
EMU	European Monetary Union
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign direct investment

GDP	Gross domestic product
GFEC	Great financial and economic crisis
GNP	Gross national product
IMF	International Monetary Fund
M.P.	Member of Parliament
OECD	Organisation for Economic Co-operation and Development
OMC	Open Method of Coordination
PIGS	Controversial grouping acronym for Portugal, Ireland, Greece and Spain
SGP	Stability and Growth Pact
SMP	Securities Markets Programme
SPV	Special purpose vehicle
SWP	Stiftung Wissenschaft und Politik / German Institute for International and Security Affairs
TFEU	Treaties of the European Union
U.K.	United Kingdom of Great Britain and Northern Ireland
ULC	Unit labour costs
U.S.	United States of America
VAT	Value added tax
WTO	World Trade Organization

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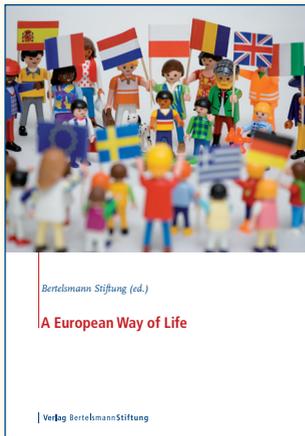
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