SWP
Stiftung Wissenschaft und Politik
German Institute for International
and Security Affairs

Arbeitskreis
Europäische
Integration
e.V.

Rolf Caesar, Wim Kösters, Hans-Helmut Kotz and Daniela Schwarzer (Eds.)

Governing the Eurozone

Looking ahead after the First Decade

December 2009
Berlin

SWP
Stiftung Wissenschaft und
Politik
German Institute for
International and
Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

Table of Contents

Introduction

Rolf Caesar, Wim Kösters, Hans-Helmut Kotz and Daniela Schwarzer

In the midst of the current financial and economic crisis, the Euro turned ten on January 1st, 2009. A decade of its existence provided ample empirical data on its internal functioning both in economic and in governance terms. Meanwhile the shock of the financial crisis and the following real economic slump is widely seen as a crucial test to the single currency. Hence, the political debate on the functioning of the Eurozone and its governance has recently gained intensity while more profound academic studies provide valuable background analysis.

In this context, a conference entitled "The Euro at Ten: Governing the Eurozone in a Globalised World Economy" was co-organised by the Stiftung Wissenschaft und Politik and the Arbeitskreis Europäische Integration with the financial support of the European Commission in December 2008. It brought together leading international experts and practitioners from European and national institutions to discuss the internal and international governance problems the European Monetary Union (EMU) is facing. The objective was both to reach an overall assessment of the functioning of the Eurozone, including its international dimension, and to hold a policy-oriented debate on possible reforms.

This volume contains the contributions to the conference. The volume is partly financed by the European Commission, but the sole responsibility lies with the authors and the European Commission is not responsible for any use that may be made of the information contained therein. Due to the fast moving economic, financial and political developments in the course of the current crisis, some of the contributions have been updated in the course of the year 2009 to offer an up-to-date and in-depth analysis of the governance problems in the EMU.

While the contributors generally agree that the first ten years of the Euro were a success, the current economic and financial crisis is generally seen as a major test to the European Monetary Union. EMU governance under the conditions of the financial and economic crisis has both proven to be flexible in many regards whilst revealing the need for institutional, procedural and policy adjustments.

European Central Bank-Board member *Gertrude Tumpel-Gugerell* discusses the main accomplishments and the challenges faced by the Euro area, both within the current conjuncture, and from a longer-term perspective. In particular, the article highlights that EMU has been very successful in delivering an environment of macroeconomic stability with low inflation and low interest rates. Moreover, EMU has provided protection against some of the potential consequences of the worst financial storm since the end of the 1920s. Nonetheless, the article also points to a number of areas which can contribute to reinforce the success of the Euro, namely the further increase in EMUs growth potential, the soundness of public finances and the need for regulatory reform.

Pervenche Berès, Chairwomen of the Committee on Economic and Monetary Affairs of the European Parliament at the time of the conference, now Chairwomen of the Committee on Employment and Social Affairs, gave the European Parliament's view on EMU's performance and necessary reforms to be undertaken. With reference to the European Parliament's report "EMU@ten", she argues that the coordination of economic and fiscal policies as well as European banking supervision need to be improved while a new commitment to the preventive arm of the Stability and Growth Pact as well as to the sustainability of public finances was needed. Regarding the international role of the Euro, the Parliament has underlined the importance of a common European position in international forums such as the International Monetary Fund. It suggests a single seat for the Euro area in international financial institutions and forums and urges the member states to speak with a single voice with regard to exchange rate policies.

Holger Schmieding, Chief European Economist at the Bank of America Merrill Lynch, evaluates the economic performance of the EMU since its launch in 1999. During the first ten years, he finds that EMU performed well on average with regard to price stability, growth and employment. Regarding fiscal discipline he underlines the downsizing of the public sector and the reduction of fiscal deficits. Structural reforms meanwhile progressed in some countries such as Germany, while other Eurozone members continue to have underlying competitiveness problems and will need to bring their unit labour costs in line with productivity. As a result of the current crisis, new challenges arose for the EMU: the ECB faced unexpected situations in which it was not able to act swiftly enough, unemployment soared in some countries that are particularly affected by an economic downturn, and inter-European spreads on government bonds have fuelled discussions on possible sovereign defaults.

Martin Marcussen, Associate Professor at the Department of Political Science of the University of Copenhagen, turns to the question of whether the European Economic and Monetary Union has actually contributed to more convergence or divergence in the EU. The EMU is generally conceived as a harmonisation project. To qualify for EMU membership it takes harmonious and convergent economic development, and the expected result of participating in European monetary cooperation is increased synchronisation of decision making and economic cycles. Marcussen explains that, however, with hindsight it becomes increasingly clear that EMU can just as well be thought of as a differentiation project. In many regards, the EMU seems to foster economic, political and institutional divergence, rather than convergence.

Against the experience of the economic crisis the paper by *Werner Ebert and Christian Kastrop*, German Federal Ministry of Finance, develops ideas for the governance of the Euro area in the next decade. They suggest measures to ensure sound, sustainable and growth enhancing public finances, a strengthened structural policy coordination between Euro area members and a clearer surveillance of macroeconomic imbalances in a coherent institutional setting. In that respect the Lisbon Strategy is to be translated into the Euro area and a systematic competitiveness review should be implemented. In addition, a better coordination in an international setting and a deeper dialogue on the macroeconomic policy-mix are proposed.

Centre for European Policy Studies Chief Executive *Karel Lannoo* analyses the recent developments in EU financial supervision. The European Council meeting of June 2009 charged the European Commission with the responsibility of drafting, "by early autumn 2009 at the latest", the proposals to implement a new framework for EU financial supervision, as called for by the de Larosière Committee. Lannoo outlines the challenges and pitfalls that the Commission faces in developing the objectives, functions, organisation, governance and funding of essentially four new entities: a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS), comprising three functional authorities. Given that these ambitious measures come on top of other proposed initiatives resulting from G20 commitments and that they will have to be pushed through in a context of a new European Parliament and a new European Commission, he cautions against expecting a swift or easy decision process.

Stefan Collignon, Professor of Political Economy at the Sant'Anna School of Advanced Studies in Pisa and Chairman of the Scientific Committee Centro Europa Ricerche (CER) in Rome, discusses the challenges for democratic legitimacy and efficient governance in the EU in general and in the European Monetary Union in particular. He perceives a deteriorating legitimacy of the integration project and argues that this sentiment of disenchantment towards the EU could spill over to European Monetary Union. The crisis of legitimacy originates from the diminishing capacity of today's intergovernmental governance to produce results efficiently, because the current set-up does not compensate this loss with additional democratic input legitimacy. A democratic European government could solve these problems in particular for the European Monetary Union which constitutes the most densely integrated core of the EU.

Turning to the question of international exchange rate regimes, *David Marsh*, Chairman at the London and Oxford Group, argues that a consistency of purpose and action would be a minimum requirement for any return to a Bretton Woods-style system of exchange rate management. In his view, the absence of this precondition was one of the reasons why a return to globally managed exchange rates appears remote indeed. Marsh explains that this is not necessarily a bad outcome: pegging exchange rates without the wherewithal to support economies that become out of kilter because of structural and cyclical differences would arguably be a retrograde step that would add to rather than obviate the causes of instability in the world economy. There were longer-term questions about the Euro that have been sharpened by the economic and financial crisis. European governments should find comprehensive answers to these questions. Otherwise, the durability of EMU in coming years would not be assured.

According to *Wolf Schäfer*, Institute for European Integration, Europa-Kolleg Hamburg, the revival of a multilateral exchange rate system (ERS) with one single currency and binding global rules for national exchange rate management is not a viable or realistic option. Schäfer considers that it is more realistic that the present 3-polar ERS in the medium term could dynamically enlarge to a 4-polar – in the long run even to a multipolar – system especially when taking China into account. In this view, the global ERS is likely to be extensively characterised by a small number of competing anchor currencies (currency oligopoly) which floats vis-à-vis each other and to which pegs and managed floats are attached (satellite currencies). Globalisation contradicts international monopolies including monopoly currencies. Globalisation stimulates international competition including anchor currency competition. Schäfer underlines that this is why there is no way back to Bretton Woods or to any similar system based on only one single world anchor currency.

Altogether, the contributions to the conference and the following discussions among the participants have made clear that the EMU will be facing considerable challenges in the years to come. On the one hand, there is certainly a need for improving economic and political cooperation between EMU countries to overcome further crises in the EU as well as worldwide. On the other hand, this cooperation cannot substitute a sound domestic policy within member countries particularly in the fields of public finance and labour market reforms. Thus the capability of the EMU to promote European integration may still remain a topic of controversial debates and a question to be answered in the future.

Challenges for the Euro at Ten

*Gertrude Tumpel-Gugerell**

Abstract

This article discusses the main accomplishments of European Monetary Union. It also elaborates on the challenges faced by the Euro area, both within the current conjuncture, and from a longer-term perspective. In particular, the author highlights that EMU has been very successful in delivering an environment of macroeconomic stability with low inflation and low interest rates. Moreover, EMU has provided protection against some of the potential consequences of the worst financial storm since the end of the 1920s. Nonetheless, the article also points to a number of areas which can contribute to reinforce the remarkable success of the Euro, namely the further increase in EMUs growth potential, the soundness of public finances and the need for regulatory reform.

Introduction

On 1 January 2009 we celebrated the tenth anniversary of the creation of the Euro. The decision to establish European Monetary Union was not entirely uncontroversial. During the years leading up to EMU, indeed, several commentators offered gloomy projections on the viability of the common currency, with the range of predictions going from the swift break-up of the monetary union in the face of the first breeze, to the possibility that EMU might even lead to conflicts among member states. The experience of the last ten years – and especially the dramatic events in financial markets since August 2007 – have clearly shown the full extent to which such predictions were misguided.

First, since January 1999 the Euro has guaranteed to hundreds of millions of people the same extent of price stability which had traditionally been associated with the strongest among its constituent currencies. Second, the common currency has effectively protected Euro area countries from both the inflationary impulses originating on world food and energy markets, and, since August 2007, the worst financial storm since the end of the 1920s. The success of the Euro along this second dimension is testified by the simplest, and most telling indicator of all: as widely reported in the financial press, in several European countries which had not previously contemplated joining EMU, the financial crisis has led to significant shifts in public opinion in favor of Euro adoption. It is during tough economic times such as those the world economy is currently facing

* I am very grateful to Luca Benati for his valuable input.

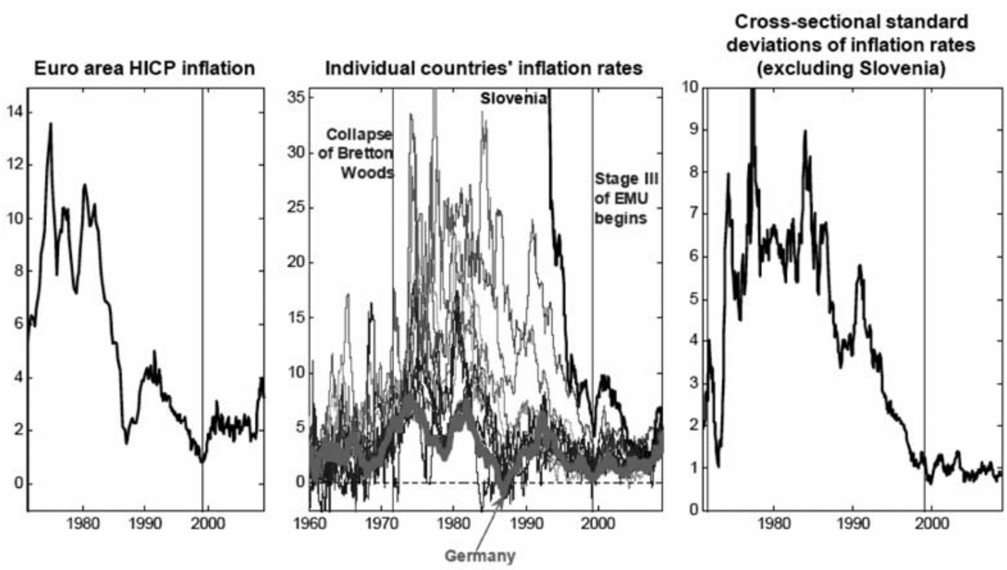
that both the benefits of belonging to a strong and stable currency area, and the dangers of 'going it alone' in an economic environment which is prone to sudden and violent swings, become fully apparent. The Euro is only ten years old, but with the current crisis it is truly coming of age.

This article will discuss the main accomplishments of European Monetary Union. It will also elaborate on the challenges faced by the Euro area, both within the current conjuncture, and from a longer-term perspective.

Key accomplishments of European Monetary Union

Figure 1 provides a clear illustration of a key accomplishment of EMU showing aggregate Euro area Harmonised Index of Consumer Prices (HICP) inflation since the collapse of Bretton Woods in August 1971. It also shows individual inflation rates for the 15 countries which, as of today, belong to the monetary union; and the evolution of the cross-sectional standard deviation of inflation rates among these countries[1] as a simple measure of heterogeneity of their inflationary experiences.

Figure 1
Inflation, and cross-sectional standard deviation of inflation rates in the Euro area



Source: L. Benati and C. Goodhart, "Monetary Policy Regimes and Economic Performance: The Historical Record, 1979–2008", in B. Friedman and M. Woodford (eds.), *Handbook of Monetary Economics*, Volume 1D, North Holland, (2010, forthcoming).

As is apparent from Figure 1, after showing some signs of instability during the years leading up to the collapse of Bretton Woods, inflation

1 In the last panel of Figure 1 the cross-sectional standard deviation has been computed by excluding Slovenia, which until the second half of the 1990s exhibited an inflation rate in excess of 20 percent (see the second panel), and can therefore be regarded as an outlier.

increased dramatically after 1971, reaching, at the Euro area-wide level, a peak of 13.6 percent in the fourth quarter of 1974. Moreover, cross-sectional dispersion of inflation rates reached a peak in excess of 9 percent in the second half of the 1970s.

Starting from the first half of the 1980s, the disinflation process was characterised by a decrease in both individual countries' inflation rates, and the extent of their cross-sectional dispersion. Under EMU, Euro area inflation has been equal, on average, to slightly more than 2 percent, and has been, by historical standards, remarkably stable.

This inflation stabilisation under EMU has been accompanied by two further key developments: first, the disappearance of inflation persistence, defined as the tendency for inflation to deviate from the central bank's price stability objective following a shock, rather than quickly reverting to it; and second, the stabilisation of inflation expectations, with the disappearance of an impact of actual inflation outcomes on agents' expectations, which is a clear indication of the credibility of our price stability objective. Both issues will be briefly elaborated in the following.

Recent European Central Bank (ECB) research[2] has shown that, after January 1999, inflation persistence has disappeared both at the aggregate, Euro area-wide level, and within its three largest countries (Germany, France, and Italy). Further, similar changes have affected inflation dynamics in several inflation-targeting countries and in Switzerland under the 'new monetary policy concept', whereas they have been largely absent in the United States and Japan, two countries characterised by a committment to price stability but lacking a clearly defined nominal anchor. As a result, in the Euro area, Switzerland, and inflation-targeting countries, inflation dynamics is – as of today – essentially purely forward-looking, whereas in countries such as the United States and Japan it still retains a significant backward-looking component.

What explains these findings? The simplest and most logical explanation is that credible and clearly defined nominal anchors, by providing a 'focal point' for agents' inflation expectations, have rescinded the link between such expectations and past inflation outcomes, which was in contrast inevitable during historical periods in which such anchors either were absent or were not regarded as credible. This conjecture is indeed compatible with the stylised fact previously mentioned: the stabilisation of inflation expectations under EMU.

Several recent studies[3] suggest that the introduction of explicit numerical targets for inflation has anchored inflation expectations, which means making them essentially unresponsive to actual macroeconomic developments – in particular, to past inflation outcomes. Beechey, Johannsen, and

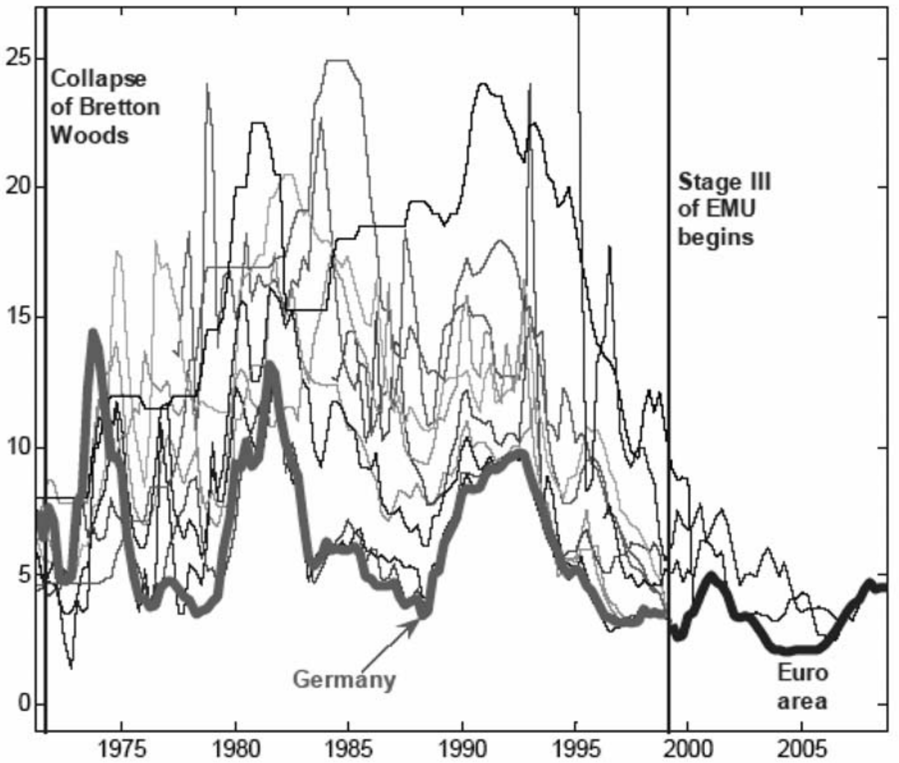
2 See Luca Benati, "Investigating Inflation Persistence Across Monetary Regimes", *Quarterly Journal of Economics* 123, 3 (August 2008): 1005–1060.

3 These studies are surveyed by Alan S. Blinder, Michael Ehrmann, Jakob de Haan, Marcel Fratzscher, and David-Jan Jansen, "Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence", *NBER Working Paper* 13932, (April 2008, forthcoming *Journal of Economic Literature*).

Levin, for example, show that long-run inflation expectations are more firmly anchored in the Euro area than in the United States.[4] They show that macroeconomic news have significant effects on U.S. forward inflation compensation – even at long horizons – whereas they only influence Euro area inflation compensation at short horizons.

Low and stable inflation, and the firm anchoring of inflation expectations, have automatically led to another fundamental achievement of European Monetary Union: historically low interest rates, with all the accompanying benefits for both consumers and firms, in terms of lower borrowing costs, see Figure 2.

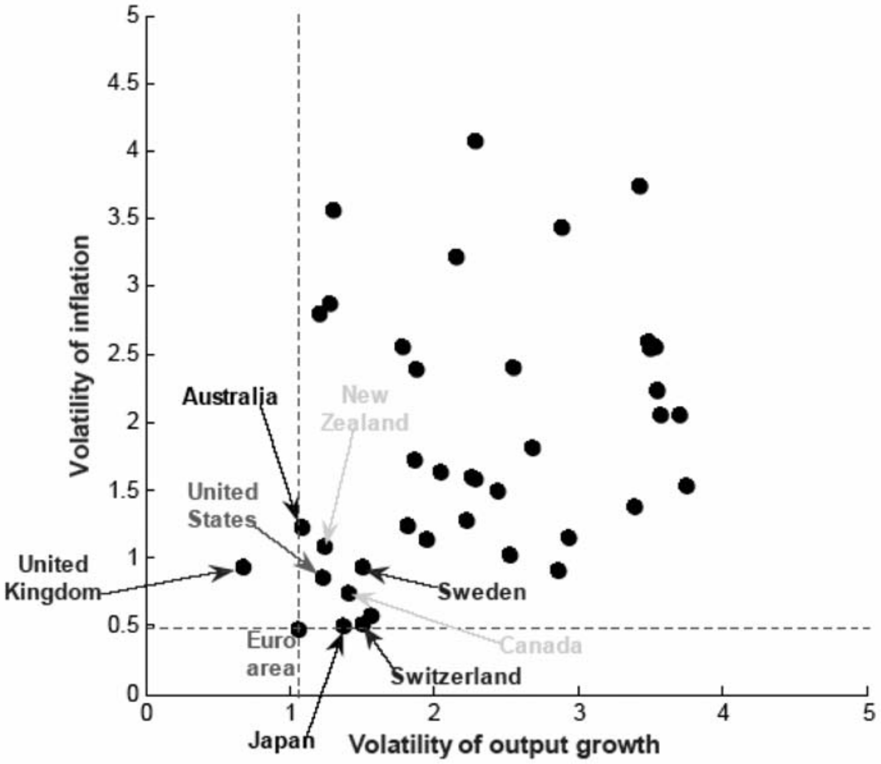
Figure 2
Short-term nominal rates in the Euro area



Overall, European Monetary Union has been associated with a remarkable stabilisation of the nominal side of the economy, with low and stable inflation, well-anchored inflation expectations, and historically low and stable nominal interest rates. A question that naturally arises is: 'Did the stabilisation of the nominal side of the economy come at the expense of developments on the real side?' Empirical evidence, however, clearly rejects such a notion along several dimensions.

4 Meredith J. Beechey, Benjamin K. Johannsen, and Andrew Levin, "Are Long-Run Inflation Expectations Anchored More Firmly in the Euro Area than in the United States?", CEPR Discussion Papers 6536, 2007.

Figure 3
Standard deviations of annual CPI inflation and output growth since January 1999



Source: L. Benati and C. Goodhart, "Monetary Policy Regimes and Economic Performance: The Historical Record, 1979–2008", in B. Friedman and M. Woodford (eds.), *Handbook of Monetary Economics*, Volume 1D, North Holland, (2010, forthcoming).

Figure 3 shows a scatterplot of the standard deviations of annual Consumer Price Inflation (CPI) and real GDP growth for the Euro area, the United States, and 47 other countries since the beginning of European Monetary Union.[5] As the figure makes clear, the performance of the Euro area has been remarkable. First, the standard deviation of Euro area inflation, equal to 0.5 percent, has been the lowest of the sample, with only Switzerland and Japan close, but slightly higher. Second, the volatility of output growth, at 1.1 percent, has been the second lowest of the sample after the United Kingdom, which has however exhibited a markedly higher volatility of inflation, equal to 0.9 percent. Third, the comparison with the United States – which, being a monetary Union of roughly similar economic size, provides the most natural benchmark – is uniformly positive, with the U.S. volatilities of inflation and output growth equal to 0.9 and 1.2, respectively. The evidence reported in Figure 3 therefore suggests that the stabilisation of the nominal side of the Euro area economy has not been achieved at the expense of the real side. Rather, the opposite appears

5 Specifically, beyond the euro area we have considered all countries for which we could find at least seven years of data in the *International Monetary Fund*'s International Financial Statistics database.

to be true, with both the real and the nominal side exhibiting an excellent performance from an international perspective.

Indeed, macroeconomic stabilisation has been accompanied by a remarkable performance in terms of job creation. First, from January 1999 until the end of 2007, the number of people employed in the Euro area has increased by 15.7 million, compared with an increase by only about 5 million during the previous nine years; second, under EMU the unemployment rate has fallen to its lowest level since the early 1980s. The improvement in Euro area labour market's performance reflects corporate restructuring, wage moderation in most countries, and – crucially – the progress made on structural reforms associated with the Lisbon process. A lot of progress in this dimension is – of course – still possible and needed.

A further benefit of the introduction of the Euro has been the strengthening of trade and financial linkages across Euro area countries. First, the sum of intra-Euro area exports and imports increased from around 31 percent of GDP in 1998 to about 40 percent in 2007. Second, the Euro has been fostering a gradual portfolio reallocation away from holdings of domestic financial instruments, and towards holdings of financial instruments issued elsewhere within the Euro area. Euro area cross-border holdings of long-term debt securities, for example, have markedly increased from about 10 percent of the overall stock at the end of the 1990s to nearly 60 percent in 2006. Notably, Euro area residents have also almost doubled the amount of cross-border holdings of equity issued within the area, from 15 percent in 1997 to 29 percent in 2006. Well-integrated Euro area financial markets, and well-diversified asset portfolios, decrease the extent to which the saving and spending decisions of firms and households depend on economic and financial developments in a specific country, region or sector. As a consequence, credit and risk-sharing channels are increasingly contributing to attenuate the impact of shocks within a specific Euro area country or sector.

Summing up, nearly ten years after the start of European Monetary Union, the common currency has to be regarded as an unqualified success, guaranteeing macroeconomic stability to hundreds of millions of European citizens, and shielding them from the direst consequences of the macroeconomic shocks which – especially in recent months – have been affecting the world economy. Many challenges however remain. The next section will be devoted to the long-term challenges.

Long-term challenges

The long-term success of European Monetary Union crucially depends on four key issues: first, increasing the long-term growth potential of the Euro area; second, making the Euro area economy more flexible and more competitive; third, pursuing sound fiscal policies; and fourth, the completion of the single market.

Although the Euro area economy's stability under EMU has been remarkable, its performance in terms of average growth rates has been less impressive. Since the beginning of the 1990s, Euro area real GDP growth has been equal, on average, to 2.1 percent, compared with 2.8 percent in the United States. Since the beginning of EMU, the annual growth rate for the Euro area has averaged 2.2 percent per year, compared with 2.7 percent in the US. A key reason for the Euro area's moderate performance is the comparatively low trend growth in labour productivity. Whereas in the 1980s, the average annual growth rate of labour productivity was equal to 2.3 percent, in the 1990s it declined to 1.8 percent, and between 1999 and 2007 it further decreased to 1.2 percent. By contrast, over the same periods average U.S. hourly labour productivity growth accelerated from 1.2 to 1.6, and then to 2.1 percent. What lies at the origin of these differences in labour productivity developments in the two areas? Specific policies targeted at increasing employment – in particularly for the unskilled segment of the labour market – certainly contributed to the decrease in labour productivity growth in the Euro area. Labour supply developments, however, can only explain a minor fraction of the overall deceleration in labour productivity growth, with the dominant portion being instead due to a significant slowdown in total factor productivity growth (or TFP growth), which is generally taken as a measure of technological progress, and of improvements in the organisation and overall efficiency of all the factors of production. Average TFP growth in the Euro area, indeed, was equal to 1.6 percent in the 1980s, and it declined to 1.1 percent in the 1990s and to 0.7 percent between 1999 and 2007.

What explains such difference between the United States and the Euro area in terms of average TFP growth? The consensus among economists points towards a clear edge, on the part of the United States, in exploiting advances in information and communication technology (ICT), due largely to a favourable regulatory environment, a superior ability to redesign management and organisational systems, the relative ease of reallocating, retraining, and shedding workers, and continued investment in research and development (R&D). In 2006, the fraction of R&D investment relative to GDP in the Euro area was only 1.9 percent, compared with 2.7 percent in the United States. This is a first dimension along which improvements ought to be made. It is also necessary to intensify cooperation between industry, universities, and public sector research institutes, in order to raise the efficiency of public R&D spending. As for investment in human capital, in several Euro area countries its rate of accumulation is still insufficient, in particular when compared with the needs of contemporary, knowledge-intensive economies. The effectiveness of the accumulation of human capital should be enhanced at all stages of the education process, by improving the quality and efficiency of our schools and universities, and should be continued through lifelong training and learning.

A further step ought to be increasing competition in both labour and product markets, thus providing strongest incentives to invest and innovate, and to ultimately boost productivity. More generally, it is necessary to support a more innovative and entrepreneur-friendly economic environment. Europe needs to create an environment which is more apt at fostering new and dynamic firms willing to reap the benefits of opening markets and to pursue creative or innovative ventures. Finally, a key requirement is for firms to be able to access relatively easily the finance they need. From this point of view, the Euro area lags behind the United States, with its venture capital financing, expressed as a fraction of overall GDP, being equal to a fraction of what it is in the U.S.

Turning more specifically to the labour market, the comparative rate of growth of working-age population is one of the key factors explaining differences in real GDP growth between the Euro area and the fastest growing industrial economies. Over the last two decades, for example, the average contribution to real GDP growth from growth of the working-age population has been approximately 0.8 percentage point higher in the United States than in the Euro area. Looking ahead, the Euro area faces the prospect of an ageing population, so the labour force could become an important constraint on trend growth.

Turning to labour utilisation, in spite of subdued growth in working-age population, over the last ten years there has been a significant increase in the total number of hours worked in the Euro area. This stands in contrast to developments in the United States, where a small deceleration has taken place. A significant portion of the acceleration in the Euro area can be explained by an increase in labour utilisation, and in particular by improvements in both participation and employment rates. Despite this progress, however, there is still room for improvements in the workings of European labour markets. First, the employment rate in the Euro area is still low by international standards. Second, the rate of unemployment in the Euro area is still high, particularly in some individual countries. In particular, whereas the employment rate for prime-age males in the Euro area is comparable to that in the United States, significant disparities between the two areas remain concerning the youth, female and older segments of the labour force. For example, in 2007 the female employment rate was 58 percent in the Euro area, compared with 66 percent in the United States, whereas the employment rates for older workers were 43.3 and 61.7 percent, respectively. Finally the youth employment rates in the two areas were 38 and 54.2, respectively.

In spite of significant achievements in job creation over the most recent years, both the still comparatively high unemployment rates in the Euro area, and the low participation rates in some countries, point towards the need to stimulate both the supply and the demand sides of the labour market. Concerning labour supply, further reforms in income tax and benefit systems would contribute to increasing incentives to work, especially for those segments of the labour force characterised by a weaker attachment to the labour market, such as women and older workers. Concerning labour demand, it is necessary to reduce labour market rigidities, in particular those restricting wage differentiation and wage flexibility, which negatively impact upon the hiring especially of younger and older workers. Under this respect, in several Euro area countries progress towards greater contractual flexibility has been comparatively slow, and employment protection legislation – especially for permanent contracts – remains quite rigid.

Beyond increasing flexibility, another key challenge for the Euro area is improving its competitiveness. In this respect, a key issue is keeping the dynamics of unit labour costs firmly under control to prevent or correct abnormal deviations. In situations in which such deviations appear, it is of paramount importance that social partners and national governments take swift action in order to address wage developments that go beyond productivity increases, so that unit labour costs in those economies increase less rapidly than the Euro area average.

The third key long-term challenge is the commitment to sound fiscal policies and, thereby, to implement the Stability and Growth Pact. There are several reasons why sound fiscal policies are a crucial prerequisite for the monetary union's long-term success. First and foremost, they are needed in order to minimise the risk of fiscal policy spillover, both into monetary policy and, more generally, across countries. Further, they are needed to increase the flexibility and adaptability of the economy. Sound fiscal policies, for example, are a necessary condition for flexibility, thus dampening business-cycle fluctuations through the workings of automatic stabilisers.

The final challenge pertains to the full completion of the Single Market, which will not only increase competition and efficiency, but also improve adjustment mechanisms in the face of adverse shocks. Under this respect, in spite of the fact that the single market was already a goal of the founding fathers of the European Union – as set out in the Treaty of Rome – there is still significant progress to be made. According to the OECD, for example, product market regulation is still high in several Euro area countries, and the extent of regulation in the Euro area considered as a whole is still significantly higher than in the United States.

The next section will elaborate on a key challenge that the Euro area is currently facing, namely how EMU deals with the current developments in financial markets.

Current challenges

The world economy is currently going through the most serious crisis since the 1930s. The factors leading up to the current turmoil were excessive growth in global credit, and historically high leverage in the financial system as well as in the non-financial sectors of some countries. Excessive credit growth and inordinately high levels of leverage, however, are not a product of nature: rather, they were the product of a specific time and of specific regulatory frameworks. In fact, the developments since August 2007 were also the outcome of minimal, or 'light touch' regulation – or even the circumvention of regulation at all – which in the views of some went so far as to maintain that markets could essentially 'self-regulate'. Therefore, the current episode will ultimately lead to a new intellectual consensus on the proper boundaries between governments and markets, first and foremost concerning the most appropriate regulation of financial markets.

Working within such a system in flux, policymakers around the globe are battling the consequences on the real economy of the strongest recessionary winds since the financial market collapse at the end of the 1920s. The situation is made especially complex by a combination of several different problems which – even taken in isolation, by themselves – would be sufficient to create significant challenges for policymakers. The following highlights the most important among them.

First of all, there is the painful realisation, on the part of consumers in several countries, that the economic strength that they had come to regard as 'natural' over the last several years seems not sustainable. To a significant extent, such strength was largely based on borrowing: borrowing against houses whose prices has been artificially inflated by bubbles and borrowing by accumulating credit card debts. Today, households in several countries have found themselves burdened by staggering amounts of debts, which prevent them from consuming precisely at a time when their consumption would be most needed to cushion the economy from the winds of recession.

Within such an environment of retrenching consumption expenditure, having well-functioning financial markets, and a strong banking system, would be of paramount importance in order to smooth out the impact on the economy. But since early August 2007 the financial sector has been engulfed by an even more serious crisis, which has required policymakers to intervene to a previously unthinkable extent. The crisis has shown the benefits of belonging to a strong and stable currency area. As a consequence, the current crisis has led to a reassessment of the desirability of joining the Euro on the part of policymakers, financial market participants, and citizens in several countries outside the Euro area.

The recent crisis has clearly shown the fundamental role played by central banks in crisis management, through the provision and management of liquidity in the money markets and – in some exceptional cases – by providing emergency liquidity to individual institutions. The ECB's provision of unlimited liquidity to the Euro area banking system at various maturities and against an expanded array of eligible collateral since mid-October has effectively mitigated concerns about liquidity risk and has, therefore, further reduced pressures in the money markets. In addition, outright purchases of covered bonds were decided by the Governing Council of the ECB to complement the liquidity measures, giving support to the financial market in enhancing the flow of credit to the non-financial sector.

Moreover, in line with the substantial weakening of global demand and economic activity, inflationary pressures and risks have been diminishing. As a result, the ECB's policy rates have been cut by 3.25 percentage points since the intensification of the crisis in October 2008. These rate reductions, together with the liquidity management measures, have had a significant impact on money market interest rates. Money market rates in the Euro area have reached very low levels by international standards and lower money market rates have also led to lower interest rates for private households and firms, although the decline in money market rates has so far been greater than the decline in interest rates on credit for households and firms.

Central banks' actions, however, can only go so far, as they cannot tackle some of the underlying causes of tensions on the money markets, first and foremost concerns about counterparty credit risk, and the continuing uncertainty on banks' other funding sources and capital positions. In this respect, the measures taken by the governments and shareholders are, therefore of paramount importance, and should address these problems over time. Moreover, it is key to ensure that there is access to financing for all sectors of the economy, especially for small and medium sized enterprises, which cannot access the capital market so easily.

Concluding remarks

To conclude the following important points ought to be kept in mind in order to reinforce the strength and resilience of the Euro area economy, thus contributing to the preservation and consolidation of the remarkable success of the Euro. First and foremost is the need to proceed along the path of structural reforms, with the firm implementation of the Lisbon strategy, as refocused and reinforced by the EU Council. This is crucial to increase the Euro area's growth potential, foster job creation, and increase the resilience of the economy in the face of shocks. A second key issue is the need to regularly monitor developments in unit labour costs across Euro area countries. In particular, in those countries which have witnessed sizeable cumulative increases in unit labour costs above and beyond the Euro area average, with the resulting loss in competitiveness, it is essential that all social partners fully understand the importance of cost and price moderation within the context of the Monetary Union. Third, it is of crucial importance – especially within the current uncertain environment – to preserve the public's trust in the soundness and long-term sustainability of fiscal policies. And fourth, it is important to get the regulatory response right. Market participants cannot go back to the business models of the 60s and 70s. However, the regulatory and institutional framework for the financial sector as well as business models, risk taking and corporate governance should be reviewed with an open mind in the interest of long term prosperity and stability.

To close with a positive note, it is important to remember the benefits the Euro has brought to hundreds of millions of people: low inflation and low interest rates, macroeconomic stability, and – at the current juncture – the Euro has provided protection against some of the potential consequences of the worst financial storm since the end of the 1920s. The ECB will certainly stand up to current as well as future challenges, preserving and reinforcing the success of the Euro in the years to come.

Performance of EMU at Ten: The European Parliament's View

Pervenche Berès

Abstract

The economic situation we are confronted with today is a real stress test for the EMU and the single monetary policy. Against this background, this contribution examines the question of economic governance inside the Euro area from the European Parliament's viewpoint – in particular regarding the macro-economic difficulties we are confronted with today – as well as the issue of the supervision of financial markets.The author argues that the coordination of economic and fiscal policies as well as European banking supervision need to be improved while a new commitment to the preventive arm of the Stability and Growth Pact as well as to the sustainability of public finances was needed.In line with the European Parliaments point of view with regard to the international role of the Euro, the Parliament has underlined the importance of a common European position in international forums such as the International Monetary Fund. She also suggests a single seat for the Euro area in international financial institutions and forums and urges the member states to speak with a single voice with regard to exchange rate policies.

Introduction

The economic situation we are confronted with today is a real stress test for the EMU and the single monetary policy. There were some hick-ups and tensions during the first ten years, such as in applying the Stability and Growth Pact to changing economic circumstances and problems with the reliability of statistics by some Member States. But these developments were clearly not comparable to the present challenges resulting from the financial crisis and the severe economic downturn, as the latter are real stress tests for the whole of the Euro area.

At present we are in the midst of the biggest economic and perhaps political challenge so far. Hence, the recommendations in the Commission Communication on EMU@10[1] may only give a partial picture. The content would be different were it to be written now or next spring, for instance with regard to Eurobonds in the light of sovereign default risks to be granted in return for stronger multilateral surveillance, or solidarity with none Euro zone member states, fiscal coordination strategies, a more com-

1 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, "EMU@10: Successes and Challenges after Ten years of Economic and Monetary Union", COM(2008)238 final, 7 May 2008, http://ec.europa.eu/economy_finance/emu10/com2008_238en.pdf.

mon approach to public debt issues and management and a unified representation at international level. It may even still be too soon to draw the final conclusions of how to improve the functioning of the Euro area, as all impacts of the global credit crisis have yet to be seen.

We are, however, confronted with the question of how to co-ordinate economic policy in the Euro area under a recession regarding recovery strategies as well as what is now called "exit" strategy. The Heads of State and Government have shown how reluctant they can be to respond to and to finance the proposals of the Commission to establish a European Economic Recovery Plan.[2] The conclusions by Ecofin were not very far reaching in this respect, stating:

"welcoming that the Commission proposal is a *good basis for designing* a comprehensive, consistent and coordinated response, taking into account the specificities of Member States and agreeing that a package in the magnitude of 1.5 percent of GDP *would* provide a significant stimulus to our economies"

Unfortunately, it fell quite short of deciding on any concrete and co-ordinated measures in this respect and does not even mention the use of the unused part of the European budget.

Against this background, this contribution will examine the question of economic governance inside the Euro area from the European Parliament's viewpoint – in particular regarding the macro-economic difficulties we are confronted with today – as well as the issue of the supervision of financial markets.

Why is co-ordination of economic policies needed both during upturns and downturns?

The Commission dwelled in length in its Communication on why broader and deeper surveillance of Member States' economies is needed during "normal times". The main argument was the need to prevent individual Member States from losing competitiveness, as gaining back lost competitiveness may only be done through difficult structural reforms to increase productivity or through a country specific recession. There are no other ways to change the real unit costs of the labour force in a monetary union.

Some degree of fiscal policy coordination would be useful during downturns, such as today.

The European Parliament's report on EMU@10[3] emphasises the following:

"economic coordination should take the form of an integrated 'European Economic and Employment Strategy' on the basis of the existing eco-

2 Communication from the Commission to the European Council, "A European Economic Recovery Plan", COM(2008)800 final, Brussels, 26 November 2008, http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf.

3 Resolution of the European Parliament, "EMU@10: The First Ten Years of Economic and Monetary Union and Future Challenges", adopted on November 18th, 2008; www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0543+0+DOC+XML+V0//EN.

nomic policy instruments – in particular the Lisbon Strategy, the Integrated Guidelines, the Sustainable Development Strategy, and the convergence and stability programmes; *and we call upon Member States', under the leadership of the president of the Eurogroup, to support economic activity in a coherent manner, at the same moment and in the same direction*."

Common orientations in the Euro area are necessary more than ever. These actions should be based on principles in line with the Commission Communication of November 26th 2008 entitled "A European Economic Recovery Plan"[4] but also on the report the Commission has issued on sustainability of public finance.

- The EU policy recommendation should optimally be common across the EU of course, taking into account different national contexts, and would need to suit all Member States in order to have the greatest effect. If only some Member States were advised to take stimulative actions, it would not be effective due to externalities and free-rider concerns. In fact, *stimulative* fiscal policy actions could have a greater effect than non-coordinated stimulative actions. Naturally, the automatic stabiliser may work as a common stimulative instrument, but it will not be enough in this case. This is particularly the case as monetary policy is not enough under these exceptional circumstances where even low and decreasing interest rates do little to overcome the credit crunch and when these rates decrease this is not effectively passed on to the companies and households because of credit risks in the economy.
- The stimulative actions should be *quick and simple to implement* and should optimally have a direct effect on the purchasing power of the consumers and the employment situation;
- Any short-run stimulus initiative should be combined with strict commitments on the *sustainability of the public finances*. Otherwise the initiative would not be effective, as consumers and the market would not have the trust in its long term effects. Member States, in particular those with high deficit and debt levels, would need to present detailed programmes on how to improve their budgetary positions in the medium term;
- A political commitment to increase the *effectiveness of the preventive arm of the Stability and Growth Pact* would need to be part of any stimulus package. Otherwise free rider risks would remain. Member States that have taken actions under "good times" to improve their budgetary position would need to be sure that those who have not would be forced to do so in the next growth cycle. So in this sense stronger EU-level economic governance would be necessary in both good and bad times.

The European Parliament also recommended in its report that:

"a binding framework within which Euro area Member States consult each other and the Commission before taking major economic policy

4 Communication from the Commission to the European Council, "A European Economic Recovery Plan", COM(2008)800 final, Brussels, 26 November 2008, http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf.

decisions, such as in the case of measures to tackle higher food and energy prices, should be established."

This is a crucial part of a fiscal framework at EU-level. It is in the interest of all concerned that a "subsidy race" be prevented between Member States. Direct or indirect fiscal aid to national industries only increases the public deficit and is therefore not effective if these policies undermine each other on the EU-level. Non-cooperative actions may increase some citizens' welfare for a while, but worsen the total welfare for all involved in the longer run. All major national fiscal initiatives aimed at supporting national industry and exports should therefore be coordinated at the EU level. It should be welcomed that Commissioner Kroes is working hard to give common guidelines on how state aid should be granted under these exceptional circumstances.

The European Parliament also recommended that a stronger link between the Integrated Guidelines, in particular the Broad Economic Policy Guidelines (BEPG), and the stability and convergence programmes, should be established. This would mean for instance that:

- the stability and convergence programmes and the National Reform Programmes could be presented at the same time (annually at the beginning of autumn) after a debate in the national parliaments;
- the BEPGs could include common budgetary objectives in line with the preventive arm of the Stability and Growth Pact (SGP); and
- Member States' forecasts should be based on common assumptions on the main economic parameters;

It should also be appreciated that the Commission has asked Member States to send in updates by the end of 2008 on their stability and convergence programmes. Without up-to-date information economic policy coordination at the EU-level is meaningless. In order to discuss Member States' fiscal policy, it is also important that the Commission updates its forecasts, which was done in January 2009.

Looking back at the first ten years, more could have been done to improve economic governance at the EU-level. Hopefully, this discussion will continue and some concrete improvements may be decided upon, while improving the existing economic instruments, in particular the Broad Economic Policy Guidelines. Finally, during the decision making on the post-2010 Lisbon strategy, we should have an open and frank debate on how fiscal policy coordination in the Euro area may be improved. This may require a stronger institutional set-up for the Euro area in line with the Lisbon Treaty but it will still be confronted with the difficulties of any further steps on the taxation harmonisation debate.

The current situation tells us that it can be dangerous to get blinded by the floodlight of price stability and yet not to take care of the wave that can submerge you.

Financial markets and supervision

On financial market reform the Parliament has been one of the main players and it has traditionally been the one pushing for more regulation to harmonise the internal market. On financial market supervision the Parliament has for a long time wanted to go faster than the Commission and Member States.The Parliament has welcomed the recommendations of the Jacques de Larosière group on supervision and will now fully take its part in the legislative process under way to implement these proposals. In doing so the Parliament needs to ensure that investor protection and systemic risk are equally important and that all stakeholders are involved. One of the lessons to be drawn from the crisis is that self-regulation has failed, so let's be cautious about overburdening and over-tasking Central Banks.

After this legislative piece will be adopted, the Parliament will need to reflect on the medium to long term perspective for European supervision. This will be one of the tasks of the recently created special committee on the financial, economic and social crisis. This means that the Parliament is willing to remain a leading and forward-looking actor in this debate.

When the Wise Men group chaired by Baron Lamfalussy was established in 2000, the mandate for their work explicitly excluded issues related to prudential supervision (see page 3 of the mandate[5]: "It will not, however, deal with the prudential supervision."). The last time Mr Lamfalussy came to the European Parliament for a public hearing he mentioned this aspect himself. The Lamfalussy framework was established to improve the EU-legislative framework and make it more flexible, but not to improve day-to-day prudential supervision. This is a subject where the impact on macro-economy needs to be better taken into account. The Commission has already been asked to do so in the European Parliament's annual 2006 report on the ECB. For the future, the organisation of the Commission should be changed to integrate financial market services within DG ECFIN.

The Euro on the global scene

It should be welcomed that the EU has been pushing this autumn for a proactive role globally, in restructuring the global financial architecture.

Up to now, the Euro has only been used in a passive manner to protect a Euro zone member's economy. In its report on EMU@10, the European Parliament stresses the need for a common European reaction within international forums, notably the FSF and the IMF, and recalls that the most effective way for the Euro area to align its influence with its economic weight is by developing common positions and consolidating its representation; and ultimately by obtaining a single seat in the relevant international financial institutions and forums. The Parliament also urges the

5 Ecofin Council, "Regulation of European Securities Markets – Terms of Reference for the Committee of Wise Man", 10491/00, Brussels, 17 July 2000, http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/mandate_en.pdf.

Euro area Member States to speak with a single voice on exchange rate policies.

Furthermore, the European Parliament calls for a world monetary conference to be organised under the auspices of the IMF in order to hold global consultations on monetary questions; it asks as well for consideration to be given to the feasibility of setting up a monetary disputes settlement mechanism within the framework of the IMF. It should be underlined that the Ecofin recently agreed to step up its work in this area. It took us ten years to create the Euro, it is now our currency but we still don't use it as our tool to build up a new multilateral system. This needs to change; otherwise we will remain observers -or worse, victims- of US and China confrontations, talks or deals.

Concluding remarks

The Euro is a public good for all of us. All of us have a responsibility regarding its value internally and externally. We also have the responsibility to work in such a way that all citizens will trust the value of the Euro as their legal tender. They need to regard the economic policy as legitimate and they need to be able to use the Euro without any practical problems. Therefore both macro and micro (economic) policy are of major importance for the success of the Euro and the functioning of the Euro area.

The Euro at 11: A Qualified Success

Holger Schmieding

Abstract

The eleven-year history of the Euro is a qualified success. Despite some ECB mistakes between June 2008 and May 2009, the overall record so far has been good. For instance, the region has mastered with flying colours one of the gravest possible tests of its internal coherence, namely a wrenching 4-year adjustment crisis in its biggest and probably most euro-sceptic member, Germany. The Eurozone is also emerging from the vicious post-Lehman recession faster than most observers had thought possible. This suggests that the ECB and the Eurozone will be able to master future challenges as well. All in all, the ECB and the Euro have done significantly better than the Euro-sceptics had feared.

The first ten years

When the European Central Bank (ECB) celebrated its 10-year anniversary on 1 June 2008, the bankers as well as the politicians who founded the ECB were able to look back at a remarkable decade. By any reasonable measure, the history of the Euro had been an almost unqualified success until that point. Before we consider the challenges facing the ECB since then, it is worth reflecting on the performance record of the first ten years. Comparing the latest data available in mid-2008 to the situation at the end of 1998, that is, just ahead of the formal introduction of the common currency, we find the following:

- Consumer prices had risen by a total of 23 percent, equivalent to an average annual inflation rate of 2.25 percent. The ECB had come very close to delivering price stability, in other words keeping inflation below 2 percent[1].
- However, if we strip out energy and food, core inflation averaged 1.65 percent per year. Those prices on which the ECB has a discernible influence, that is those which are set by the balance of domestic demand and supply, have thus moved fully in line with the ECB target. Arguably, the ECB had done exactly the right thing. The ECB had not tried to squeeze domestic demand so aggressively that a weaker economic performance would keep headline inflation below 2 percent in the face of a major surge in energy prices. Of course, the pressure exerted by the integration of China and post-communist Europe into the world economy on domestic wage costs and import prices of manufactured goods helped.

1 Unless noted otherwise, all data are taken from Eurostat.

- Real GDP in the Eurozone rose at an average rate of 2.2 percent, slightly above our 2.0 percent estimate of trend growth.
- Since the end of 1998, the Eurozone had created an additional 16.1 million jobs, a rise in employment by a staggering 12.5 percent.
- Unemployment had fallen from a rate of 9.8 percent to 7.1 percent.
- The real gross disposable income of households had advanced by 16.3 percent, equivalent to an annual gain of 1.64 percent.
- The effective exchange rate of the Euro had risen by 21 percent in nominal terms against a broad group and by 12.5 percent against a smaller group of – more stable – partner countries.
- The public sector had successfully downsized itself, with the share of public spending in GDP falling from 48.5 percent in 1998 to an estimated 46.1 percent in 2008, according to OECD data.
- As a result, the Eurozone was able to cut its fiscal deficit from 2.3 percent to 0.7 percent of GDP in 2007.
- Fiscal restrain also left room to cut the tax burden from 46.3 percent to an estimated 45.3 percent of GDP, measured as the share of general government tax and non-tax receipts in GDP.

Of course, politics is always messy, but by and large -and in a rather bumpy process- the Eurozone countries had delivered a series of structural reforms until the year 2008. The region had also mastered with flying colours one of the gravest possible tests of its internal coherence, namely a wrenching 4-year adjustment crisis in its biggest and probably most eurosceptic member, Germany. From early 2001 to early 2005, the German economy expanded only by a cumulative total of 0.65 percent while the Eurozone outside Germany managed a 6.3 percent rise. The subsequent German turnaround, from the "sick man of Europe" (the label we coined in 1998) to an attractive location to invest and create jobs in 2007 and early 2008 shows that countries can successfully reform themselves within the strictures of monetary union.

In terms of the gains in GDP and disposable incomes, the Eurozone had lagged behind the UK and the US. For instance, GDP rose at an average annual rate of 2.7 percent in the UK and 2.6 percent in the US at the same time. This was not surprising. The Anglo-Saxon countries started with a higher trend rate of growth due to their more flexible labour markets and some other structural advantages. They also enjoyed the dubious pleasure of a debt-fuelled real estate boom. But the underlying trend seemed to turn into the Eurozone's friend. On some key structural characteristics, the region narrowed the gap. Britain, for instance, had a very chequered record of labour market policy during those ten years, with a new minimum wage that is turning out to be ever more harmful on the negative side and a high degree of openness to immigrants from new EU countries on the positive side. The Eurozone had moved mostly one way, towards less inflexible labour markets. While the Eurozone downsized its overblown government sector (see above), the share of government spending in GDP rose from 40.0 percent to an estimated 44.8 percent in Britain and from 34.7 percent to an estimated 37.6 percent in the US (OECD data for

2007). Also, the 12.5 percent gain in Eurozone employment beat the US (8.2 percent) and the UK (9.4 percent) by a wide margin.

Of course, singing the praise of the Eurozone does not mean to attribute all the successes to the ECB. The structural reforms enacted by many governments of various political stripes contributed much more to the outstanding labour market improvement than ECB policy. But two key points are worth making:

- The effort which countries put in to qualify for monetary union paid a dividend.
- Whatever the niceties of academic debates about optimal currency unions, the Eurozone and its member countries did show that they can cope with severe and very diverse challenges. ECB policy has not been any impediment to reform progress.

All predictions that monetary union would be a disaster, that the Eurozone would inevitably head for ever more trouble and may even break apart, were mistaken. The record of the ECB's first ten years was really quite good.

Some serious mistakes

Unfortunately, history did not stop there. Immediately after celebrating its tenth birthday, the ECB made two serious mistakes.

- On 3 July 2008, the ECB reacted to the oil-driven spike in headline inflation to a 4 percent peak by raising interest rates by 25bp. The bank had de facto pre-announced this step and had already adopted a hawkish rhetoric at its June meeting already. The rate hike came at a time when the available data already suggested that the Eurozone economy was stagnating in the wake of a surge in oil prices, a strong rise in the Euro exchange rate was apparent, and amid mounting problems in various real estate markets outside the Eurozone and within. At the time, the financial industry in the Western world, including very prominently in the Eurozone, already looked shaky, struggling to digest the losses related to US mortgage-backed securities (subprime and others). Stirred by the ECB shift to a belligerent stance, the rates market briefly priced in up to three rate hikes of 25bp. With the yield curve flattening accordingly, banks were denied the opportunity to replenish their profits by playing the yield curve at a critical time.
- After the ill-managed Lehman failure triggered the monetary equivalent of a heart attack in global financial markets in September 2008, the ECB reacted fast with further liquidity injections and some modest rate cuts. However, the ECB was too slow, and much slower than almost all other leading central banks, to slash rates decisively. It took the ECB far too long to realise the seriousness of the unfolding recession. In the six months after Lehman, ECB staff projections were usually outdated before they were officially published. The ECB seemed to act as if it could not believe that the Eurozone may fall into a more serious recession than the US. While the US Fed adopted a very accommodative rate

policy by December 2008 and started a very aggressive programme of non-standard measures in March 2009, the ECB only reached a 1 percent refinancing rate in May 2009 and pursued its most important non-standard measure, its 12-month refinancing auction with full allotment at a 1 percent refinancing rate, only in late June 2009.

The delayed ECB response to the crisis may somewhat have exacerbated the Eurozone recession. It took the ECB until mid-2009 to get its response to the crisis right.

The recession has partly reversed some of the key achievements of the previous ten years. For instance, as the boom in Spanish residential construction turned to bust, unemployment in Spain increased by 2.4 mn between the end of 2007 and May 2009. This alone has undone 15 percent of the entire Eurozone employment gains in the ten years before.

Still, the situation in mid-2009 is not quite as bad as some of the scare stories circulating in markets in February and March had suggested. Leading indicators suggest that the Eurozone will start to recover in the second half of 2009, and thus much earlier than many observers including the ECB had believed in the first half of the year. Chances are that the Eurozone will surpass the 1.6 percent GDP growth forecast we had made at the end of 2008 for 2010. However, the recovery may initially be a little more muted than in the US despite the more serious real estate problems on the other side of the Atlantic.

Euro break-up? Nowhere close

The financial turmoil since September 2008, and the resultant plunge in export orders, has hit the Eurozone largely as a symmetric shock, pushing virtually all member countries into a deep recession. As a result, the Eurozone looked more and not less cohesive after the start of the crisis than prior to it, when some countries such as post-bubble Spain and Ireland were beginning to reel under a domestic real estate crisis while others such as Germany and Austria were still doing fine. In this sense, the common crisis, and the response by governments and the ECB, have further reduced the risk that some countries would decide to leave the Eurozone and turn back to their old-devaluation prone currencies in the foreseeable future. Instead, the Euro turned into a beacon of stability, with other countries ranging from Denmark to Poland and possibly even Iceland now more eager than before to adopt the Euro (and join the EU in the case of Iceland) as soon as they can.

Of course, the sharp widening in intra-European spreads for government bonds in early 2009 seems to tell a different story. As budget deficits are soaring, probably to more than 12 percent of GDP in Ireland in 2009, the market is discussing the risk that some countries may no longer be able to fund themselves on the capital market and may have to make an Argentinian-style exit from monetary union. All in all, much of the debate seems to be misplaced.

We need to distinguish clearly between the risk of sovereign default within the Eurozone and an exit from monetary union. As fiscal deficits rise and governments in some peripheral Euro members have to pay much higher spreads over Bunds when issuing new debt, the risk that a member government may get close to the point where it cannot fund itself on the capital market and may have to default on some of its debt is still small. But it is no longer negligible. If this were to occur, the government would almost certainly be offered conditional help from its partners and the EU itself. German finance minister Steinbrueck explicitly confirmed this in mid-February, raising the bail-out offer from an implicit understanding to a clear commitment. Such a bail-out may, for instance, take the form that the other Eurozone members and/or the EU underwrite the issuance of new government debt for the crisis country with a guarantee. In return, the guarantors would demand a credible programme of how to put the beneficiary's budget in order again, roughly along the lines of conditions often set by the IMF.

With such a bail-out offer, an actual sovereign default within the Eurozone should be highly unlikely. And in the extreme case that a default happened nonetheless, this would still not mean that the stricken government would take its country out of the EMU. A brief look at Iceland, for instance, should suffice to convince governments and voters that it is better to suffer some inevitable pain within the Eurozone than to be left out in the cold.

Any country wanting to leave monetary union in order to then devalue its way out of competitiveness problems would probably face a punitive increase in risk premia. For countries such as Italy with a 120 percent ratio of public debt to GDP, this would particularly be a problem. A break-up of the EMU remains highly unlikely for the foreseeable future, in our view.

Of course, in the current severe recession across Europe and the globe, many calamities which seemed to be virtually unthinkable before may no longer be unthinkable. Policy mistakes happen, and a worsening crisis could theoretically elicit responses which we would deem irrational. While we should never say never in the wake of the post-Lehman turmoil, our point is that an actual break-up of the Eurozone is not high on our list of potential macro-disasters. In the highly unlikely case that the current crisis continues to worsen to the extent that we have to seriously consider the risk of a break-up of the Eurozone, we would probably have experienced quite a few different other macro-disasters across the globe first.

European imbalances: A time bomb?

The global current account imbalances between nations with a high savings rate (such as China, Japan, Germany and some major oil exporting countries) and those with high consumption relative to domestic investment (especially the United States and, to a much smaller degree, the United Kingdom), have been a focal point of discussion for many years ahead of the 2008–2009 crisis. Europe has a similar issue. Although the current account of the Eurozone as a whole has been largely balanced, apart from some largely oil-induced fluctuations, the aggregate has hidden huge imbalances within the region. While Germany ran a current account surplus of almost 7 percent of GDP in 2008, some other nations had huge deficits, with Greece (deficit of 14 percent of its GDP), Spain and Portugal (deficits of roughly 10 percent of their GDP) leading the group, followed by Ireland (about 5 percent of its GDP) and others.

Broadly speaking, the imbalances within the Eurozone arose from the divergence between nations that had supercharged their catching-up process versus core Europe with a big consumption and real estate boom (Spain, Ireland, Greece) once they were able to enjoy the common low interest rates of monetary union, and some core European countries such as Germany had used the pre-recession years to improve their international competitiveness by reining in labour costs instead. For the major deficit countries as well as for Italy and France with their more modest current account deficits (3.0 percent and 1.5 percent of GDP in 2008, respectively), the external shortfall also reflected some trend loss in global market share caused by a continuing rise in unit labour costs relative to Germany and others.

The imbalances have started to narrow sharply in late 2008 and early 2009. Most importantly, the real-estate fuelled consumption booms in many of the high-deficit countries had already come to an end over the course of 2008. While residential and business investment fell sharply in these countries, consumers became reluctant to further reduce their savings rate as unemployment soared. The gap between investment and saving, the flip-side of the external deficit, became much smaller. At the same time, the global recession injured export-oriented surplus economies such as Germany disproportionately, cutting deeply into Germany's external surplus.

Over time, Eurozone countries with an underlying competitiveness problem will need to bring their unit labour costs in line with their productivity. Some of this may happen in the wake of the current recession as the surge in unemployment is significantly dampening wage increases in the once-booming economies of Spain, Ireland and Greece.

In the long run, divergent trends in unit labour costs within the Eurozone may turn into a major problem if they are not addressed by appropriate labour market reforms in those countries with excessive wage gains and insufficient productivity growth. But as the external imbalances are likely to decline during and immediately after the current recession, we do not expect this problem to come to the fore over the next few years. Thanks to the common currency, Euro nations can run much larger imbalances with each other than previously as financing flows between them are no longer affected by nominal exchange rate risks.

All in all, the eleven-year history of the Euro is a qualified success. Despite some ECB mistakes between June 2008 and May 2009, the overall record so far suggests that the ECB and the Eurozone will be able to master future challenges as well.

United in Diversity: EMU as a Differentiation Project

*Martin Marcussen**

Abstract

The European Economic and Monetary Union is generally conceived as a harmonisation project. To qualify for EMU membership takes harmonious and convergent economic development, and the expected result of participating in European monetary cooperation is increased synchronisation of decision making and economic cycles. However, with hindsight it becomes increasingly clear that EMU can just as well be thought of as a differentiation project. In many regards, the EMU seems to foster economic, political and institutional divergence, rather than convergence.

It all started with an idea about harmonisation

Textbooks on European monetary integration typically tell the story of the German and French perspectives being in constant competition from the 1970s onwards.[1] For the Germans, the preferred strategy to follow was to let relatively harmonious economies enter into closer cooperation. If a country manages to fulfil a set of fixed criteria, these efforts should be coronated with the Euro in the final stage of the EMU process. Harmonisation first, and then membership. In contrast to such a strategy, the French have consistently argued in favour of a strategy according to which it would be a political decision, rather than a purely technical decision, whether EU-states could become Euro-insiders. With a Euro-insider status, a shared political loyalty would develop and a functional pressure towards economic coordination would unfold. Increasingly, the members of the Eurozone would come to resemble one another. Membership first, harmonisation afterwards.

Both perspectives, as different as they are, are based on the idea of harmonisation – harmonisation either as a cause or as an effect of the EMU. The EMU as we know it today is formally based on German ideas about clear convergence criteria to be fulfilled as entry tickets to the Euroarea. These are primarily nominal criteria emphasising price inflation, long term interest rates, and deficit and debt levels. The stability and growth pact has been adopted and later revised with a view to binding Euro-members to the mast of stability. Yet, the French perspective is also somehow

* Comments to the arguments presented in this chapter have been gratefully received from the participants in the SWP-AEI Conference, "The Euro at ten: Governing the Eurozone in a Globalized World Economy", Berlin, December 8, 2008, and from Rebecca Adler-Nissen and Kathrin Keil.

1 Daniel Gros and Niels Thygesen, *European Monetary Integration* (London: Longman, 1992).

built into the EMU construction. A set of meeting forums has been established, the Eurogroup, the Eurogroup working group, and possibly also a Euro-Summit constituted by the heads of state and government of the Euro-insiders. In principle, the institutional set-up allows for political coordination in order to enhance mutual understanding and a distinct European perspective on all matters related to economic and monetary integration. A case can be made, therefore, that the EMU was predominantly conceptualised as a harmonisation project. It takes a harmonious and convergent economic development to qualify for EMU membership, and the expected result of participating in European monetary cooperation is increased synchronisation of decision making and economic cycles.

However, good intentions and theoretical conceptualisation do not always work out as planned. We now have more than ten years of experience with the EMU-project in practice, and it may be the right time to consider what kind of project has actually materialised. Below it will be argued that the EMU can just as well be conceptualised as a differentiation project. There are indicators that harmonisation is taking place here and there, however, it will be demonstrated that the EMU in its own right has fostered increased economic, political and institutional differentiation. It will be concluded that just as there can be positive and negative evaluations of a harmonisation project, the EMU as a differentiation project contains both advantages and disadvantages for European integration overall. In general, it is concluded that differentiation has come to stay, and that differential Europe could just as well be considered a norm rather than an exception to an illusion about European harmony and convergence.

Differentiation – what is it?

Differentiated integration concerns the fact that different EU-member states in practice tend to participate in different ways on different policy sectors. There is general agreement that differentiated integration in Europe is *not new*.[2] It has always been the case that European regulation actually takes European diversity into account and allows for a significant amount of discretion in the implementation stage; that new countries have been granted transition periods of various lengths in different policy sectors; that member states have received opt-outs and opt-ins to various degrees; and that particularly eager member states can engage in enhanced cooperation if they wish. One could argue that in many different ways, European integration in terms of widening and deepening to a large extent has depended on a flexible approach to harmonisation, allowing for de facto differentiation.

It is not new either that differentiation is *increasingly formalised*. It is well-covered in the literature that the Maastricht, the Amsterdam and the Lisbon Treaties all helped to consolidate and formalise these patterns of dif-

2 Janis A. Emmanouilidis, "Conceptualizing a Differentiated Europe", *Policy Paper*, no. 1 (Hellenic Foundation for European and Foreign Policy, June 2008).

ferentiation.[3] It becomes increasingly clear that an à la carte Europe seems to develop according to which different EU member states are following different kinds of lode-stars, some of which even leading in totally different directions! However, the founding fathers of European integration tended to look at differentiation as something temporary and abnormal. Accordingly, differentiation should be avoided and, if unavoidable, it should be limited in scope and abolished at the first possible opportunity. A so-called union-vision of Europe contained an idea about a harmonious whole constituted by ever increasing integration by the European populations. A shared European vision among the member states is supposed to constitute the lode-star for integrative initiatives. Some would rapidly arrive at the end destination, others would be slower, but at a certain point in the future all would be together in a common destiny. Some EU-institutions have worked hard on the basis of such a paradigm of uniformity in order to re-establish harmony in a still more diversified Europe. The European Court of Justice, for instance, has proactively worked to promote uniform legal principles across the entire territory of the European Union, and the European Central Bank produces one size fits all monetary policy decisions.

If there is anything new about differentiation it must be that some large-scale integration projects were thought off as harmonisation projects but unintendedly spurred processes of differentiation. A *differentiation project* is an integrative program that creates the basis for a wide variety of different forms of differentiation – economically, politically and institutionally. As we will see, such projects make it increasingly likely that differentiated integration becomes the grundnorm in the European Union rather than the exception to some illusionary union vision.

Economic differentiation

One of the largest steps forward in the more recent history of European integration is, of course, the creation of the Economic and Monetary Union (EMU). In different shapes it has been on the European agenda for more than four decades. It has been faced with many barriers on its way to realisation more than ten years ago. The energy crises of the seventies and the break down of the Bretton Woods systems put an end to the Werner plan in the beginning of the seventies and the currency crises of 1992–93 almost did the same for the Delors plan. Once established, first electronically from 1999 and then in terms of real coins in the hands of European citizens from 2002, it also ran into a number of problems. Depreciation in relation to the US-Dollar, failed referendums in Denmark and Sweden, and below standard budget figures in the countries in the driver's seat – France

3 Funda Tekin and Wolfgang Wessels, "Flexibility within the Lisbon Treaty: Trademark or Empty Promise", *EIPASCOPE,* 1 (2008): 25–31; Gaby Umbach and Wolfgang Wessels, "Differentiation in the European System of Central Banks: Circles, Core, and Directoire", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 53–72 (Oxford: Oxford University Press, 2009).

and Germany – are among the challenges that the EMU has had to overcome. But in the advent of the tenth anniversary of the EMU it was primarily the considerable number of successes that were celebrated. In general, national budget deficits in Europe have improved since the 1990s, interest rates have been brought down, and inflation levels seem to have gone in the same direction. At the same time, levels of intra-Euro area trade have grown considerably since the inception of the Euro, the same can be said about investment levels in the Euro area. In addition, the Euro seems to have achieved a very important position as an international reserve currency and it has spurred a considerable degree of financial integration.

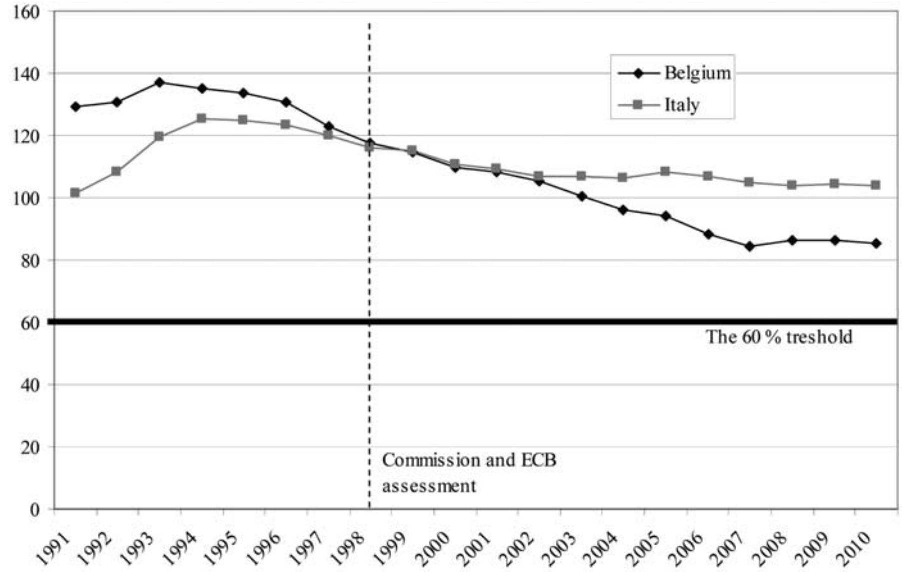
Looking back over the past decade, a number of counter-factual questions have been asked. For instance, would these positive experiences regarding inflation, interest rates, trade and investment have taken place without processes of economic globalisation and the ongoing realisation of the internal market? Indeed, this is a relevant question to answer, since many of the positive developments that have been noticed inside the Euro area have also taken place in other parts of the world.[4] In a similar vein, one could be tempted to ask whether the weakest economies in the Euro zone, had the Euro area not existed, would have suffered much more than they actually did as a result of the financial crisis of 2008 and 2009? Clearly, the Euro area can be seen as a zone of stability that helped to prevent an Icelandisation of many parts of continental Europe. These questions will not find answers in this chapter. Rather, attention will be directed towards the known effects of the EMU that were not necessarily predicted in advance of its realisation.

It can be argued that one of these effects is that the EMU, rather than creating the basis for a synchronic development among the Euro area countries, has spurred economic differentiation. This argument is based on three observations. The first observation is that *the degree of achieved harmonisation prior to the realisation of the third stage of the EMU should not be exaggerated*. In its convergence report preparing the creation of the Euro area in 1998, under the headline “Convergence is now an established fact in Europe”, the European Commission referred to the performance of the EU-member states of the preceding years as “impressive” and “outstanding”. On that basis it recommended that the Council decide that both *Belgium* and *Italy* had fulfilled all the convergence criteria and therefore had “achieved a high degree of sustainable convergence.”[5] However at this point already it was clear that none of these two countries were close to fulfilling the debt criterion requiring that general government gross debt should not exceed 60 percent of GDP (Figure 1, p. 36). Nevertheless, since both countries were able to present a clearly downward-sloping curve, the

4 Barry Eichengreen and Andrea Boltho, “The Economic Impact of European Integration”, *CEPR Discussion Paper*, 6820, May, 2008.
5 Commission of the European Communities, “Euro 1999. Report on Progress towards Convergence and Recommendation with a View to the Transition to the Third Stage of Economic and Monetary Union”, Brussels, March 25, 1998.

Commission believed that the debt ratio would be sustainable and expected it to decline even further in future years.

Figure 1
General Government gross debt as a percentage of GDP, 1991–2010



Source: Commission of the European Communities, "Economic Forecast", *European Economy*, 6/2008, Autumn, 2008; EMI and ECB *Annual Reports* (1997–2008).

Today, we know that this was only partly true for Belgium and not at all true for Italy. Over a couple of decades, the Italian public debt has never been below the 100 percent mark. Whereas before 1998 there was considerable pressure on Italian politicians to implement all kinds of reforms, the adaptational pressure apparently disappeared after Euro-entry, since "there is no longer a direct threat of exclusion from the core Europe."[6] As regards Belgium, the predictions of the Commission about declining debt ratios in future years seem to be more to the point. However, the Belgium debt is still lingering above the 80 percent mark.

In contrast to Italy and Belgium, *Greece* did not make it in the first round. With an eye on Greek performance during the months leading up to 1998, the Commission concluded that the budgetary deficits were "excessive" and that the external debt was not declining at any sustainable level. Yet, the figures reported by Greece itself indicated a considerable reduction in government deficits from 13.8 percent of GDP in 1993 to only

6 Lucia Quaglia, "Bank of Italy: Between Europeanization and Globalization", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 183–202 (Oxford: Oxford University Press, 2009); Lucia Quaglia and Paul Furlong, "Italy: Creeping Towards Convergence", in *The Euro at 10. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 204–221 (Oxford: Oxford University Press, 2008); Claudio Radaelli, "The Italian State and the Euro: Institutions, Discourse, and Policy Regimes", in *European States and the Euro. Europeanization, Variation, and Convergence*, ed. Kenneth Dyson, 212–237 (Oxford: Oxford University Press, 2002).

4 percent in 1997. As for debt, it reached a peak in 1996 of 111.6 percent of GDP before declining to 108.7 percent in 1997. In the years following the first failed attempt to enter the "core of Europe", the Greek government started to report new and very improved figures regarding its deficit and debt levels. These new and self-reported figures convinced the Commission who decided to recommend Greek entry into the Euro area from January 2001. With the benefit of hindsight we now know that "Greece's Euro entry was misjudged and even fraudulent."[7] In early 2004, with the entry of a new Greek government, it became clear that something was very wrong. The previous government had consistently reported erroneous numbers regarding its debt and deficit performance. Military spending had been under-reported and revenues had been over-reported, resulting in figures just good enough to open the gate for Greece to Euro-land. New figures were reported later in 2004 (Table 1). The real figures would never have allowed Greek entry in the Euro area. But by 2004 it was clearly too late to correct the error.

Table 1
Revision of the Greek Government Deficit and Debt Figures

	2000	*2001*	*2002*	*2003*
Self-reported deficit				
March 2004	−2.0	−1.4	−1.4	−1.7
September 2004	−4.1	−3.7	−3.7	−4.6
Self-reported Debt				
March 2004	106.1	106.6	104.6	102.6
September 2004	114.0	114.7	112.5	109.9

Source: Eurostat, "Report by Eurostat on the Revision of the Greek Government Deficit and Debt Figures", p. 3, November 22, 2004.

The price for this misjudgement seems to be paid by the future members of the Euro area. The Commission, of course, does not want a repetition of the Greek affair as a result of which it seemingly has adopted a new and more stringent interpretation of the convergence criteria. The rejection, in spring 2006, of *Lithuania's* application for Euro-entry can be seen as an example of the fact that the Commission seems to have adopted a much tougher line after the Greek affair. The reason for turning down this par-

7 Kevin Featherstone, "Greece: A Suitable Accommodation"?, in *The Euro at Ten. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 165–181 (Oxford: Oxford University Press, 2008), p. 167; see also George Pagoulatos, "Bank of Greece: Latecomer, Uphill Adjustment", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 161–82 (Oxford: Oxford University Press, 2009). The arrival of a new Greek government in 2009, headed by the Socialists, has coincided with another serious review of statistics. The chair of the Eurogroup, Jean-Claude Juncker, fumed that this had already happened several times in the past and if it were to happen again in the future, it would undermine euro zone credibility, "Exasperation at Greece's New Budget Deficit Statistics", *Agence Europe*, no. 10002, 21 October 2009.

ticular application was that price inflation in Lithuania exceeded the level set by the Commission of 2.66 percent by 0.06 percent! The threshold had been calculated by including inflation levels from two Euro-outsiders. Had the threshold inflation target been calculated on the basis of the inflation performance of the Euro-insiders, Lithuania would have passed the test.

A second observation concerns *the ability of the original Euro-insiders to respect the Stability and Growth Pact*. As we have seen, newcomers have to improve their economic performance before they can contemplate Euro-entry. At the same time, they can passively watch how the present Euro-insiders – particularly the countries in the driving seat, *France*, *Germany*, *Italy* and *Spain* – have considerable flexibility with regard to the economic constitution of the EMU. This has clearly been a disappointment for some Central and Eastern European Countries.[8] The continued breach of the Stability and Growth Pact over the 2000–2005 period led to a considerable reform of the Pact in 2005, making it more flexible. Whether the pact has a future has again become an issue during the financial crisis of 2008–2009. Because of exceptional circumstances the SGP has temporarily been suspended. How long this will be the case remains to be seen. Much will probably depend on how France and Germany perform in terms of growth, employment and export-import ratios in the years to come (Table 2, p. 39). Paradoxically, during the years 2000–2007 in a favourable global context, the Euro area could not achieve economic convergence, but in just a few months of 2008 dominated by a financial crisis, the Euro area seems to have achieved a degree of convergence around low growth and high unemployment. What still seems to be a point of divergence, however, is the fact that Germany is the Euro area country which is leading in terms of export performance.

A third observation has to do with a set of *criteria mostly related to the Lisbon's process' objective of creating the most competitive region in the world by 2010*. Innovation, business environment and competitiveness are directly related to institutional reforms undertaken by EU member states. By comparing a number of frequently applied rankings of relevance to the Lisbon process, it becomes clear that there is considerable divergence within the Euro area (Table 3, p. 40).

Among the ten best performers on the accumulated meta-ranking in Table 3 one can locate four Euro-insiders – Finland, the Netherlands, Germany and Ireland – whereas among the ten worst performers, one can identify five Euro-insiders – Greece, Malta, Italy, Cyprus, and Portugal. The impact of the financial crisis on the ability and willingness to pursue additional institutional reforms remains to be seen. The regulatory reforms that will most likely be adopted in the years to come may eventually both spur and prevent innovation in the financial and productive sectors.

8 Rachel Epstein and Juliet Johnson, "Czech Republic and Poland: The Limits of Europeanization", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 221–240 (Oxford: Oxford University Press, 2009).

Table 2
Growth down and unemployment up at the centre of the Eurozone

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Germany							
GDP	0.7	0.9	3.2	2.6	1.4	−0.8	1.2
Unemployment rate*	9.7	10.5	9.8	8.3	7.4	8.1	8.6
Balance on current account**	4.6	5.2	6.1	7.7	6.4	6.2	6.1
France							
GDP	2.2	1.9	2.4	2.1	0.9	−0.4	1.5
Unemployment rate*	8.8	8.8	8.8	8.0	7.3	−8.2	8.7
Balance on current account**	0.6	−0.6	−0.7	−1.2	−1.6	−1.5	−1.6
Spain							
GDP	3.3	3.6	3.9	3.7	1.3	−0.9	0.8
Unemployment rate*	10.5	9.2	8.5	8.3	10.9	14.2	14.8
Balance on current account**	−5.3	−7.4	−8.9	−10.1	−9.7	−7.4	−6.4
Italy							
GDP	1.4	0.7	1.9	1.4	−0.4	−1.0	0.8
Unemployment rate*	8.1	7.8	6.8	6.2	6.9	7.8	8.0
Balance on current account**	−0.9	−1.6	−2.6	−2.5	−2.6	−2.1	−2.6
Euro area OECD countries							
GDP	1.9	1.8	3.0	2.6	1.0	−0.6	1.2
Unemployment rate*	8.8	8.8	8.2	7.4	7.4	8.6	9.0
Balance on current account**	1.2	0.5	0.4	0.3	−0.4	−0.1	0.0

* as a percentage of labour force
** as a percentage of GDP
Source: OECD, *Economic Outlook*, no. 84, November (Paris: OECD, 2008).

In summary, with ten years of Euro-experience, it is not primarily convergence that characterises the Euro area. On some measures, the EMU even seems to have directly spurred processes of differentiation. One level of differentiation concerns the evaluation of the economic performance of insiders versus outsiders. A number of political factors – and not only numerical evaluations of the degree of fulfilment of the convergence criteria – influenced the judgement of the European Commission when recommending which countries ought to take part in the Euro area in 1998. Since enlargement with Greece in 2001, the Commission has seemingly adopted a more strict interpretation concerning which and under what conditions new members can be allowed to enter the Euro area. Thus, a degree of economic differentiation exists between present Euro-members and those countries which aspire to become members in the future. Another level of differentiation concerns the economic performance of the Euro-insiders. Both when it comes to the so-called Stability and Growth Pact, as well as concerning additional criteria such as employment and growth, a clear pattern of systematic differentiation has unfolded. The EMU itself has not been able to create the kind of convergence

Table 3
Meta-ranking: Measuring innovation, business environment and competitiveness

Country	*The Lisbon league table, 2008*	*The WEF Growth Competitiveness Index, 2008*	*The UNCTAD Innovation Capability Index, 2001*	*The World Bank Ease of Doing Business Ranking, 2008*	*IMD World Competitiveness Scoreboard 2008*	*EIU's Busness Environment Ranking, 2008*	*Average*
1. Denmark	1	3	4	5	6	1	**3**
2. USA	–	1	3	3	1	9	**3**
3. Finland	5	6	2	13	15	2	**7**
4. Sweden	2	4	1	14	9	10	**7**
5. Switzerland	–	2	13	16	4	5	**8**
6. Netherlands	4	10	10	21	10	7	**10**
7. UK	7	9	8	6	21	12	**11**
8. Norway	–	16	5	11	11	18	**12**
9. Germany	8	5	18	20	16	13	**13**
10. Ireland	6	22	21	8	12	11	**13**
11. Luxembourg	12	25	–	42	5	–	**14**
12. Austria	3	15	17	25	14	16	**15**
13. Japan	–	8	11	12	22	27	**16**
14. Belgium	13	20	9	19	24	15	**17**
15. France	9	18	16	31	25	17	**19**
16. Estonia	11	27	25	17	23	21	**21**
17. Spain	16	29	20	38	33	22	**26**
18. Lithuania	18	38	29	26	36	39	**31**
19. Latvia	17	45	34	22	–	38	**31**
20. Slovak Rep	20	41	39	32	30	30	**32**
21. Slovenia	10	39	23	55	32	32	**32**
22. Chec Rep.	14	33	36	56	28	28	**33**
23. Portugal	21	40	28	37	37	33	**33**
24. Hungary	22	47	32	45	38	36	**37**
25. Cyprus	15	55	43	–	–	37	**38**
26. Italy	23	46	27	53	46	40	**39**
27. Malta	27	56	–	–	–	–	**42**
28. Polen	26	51	31	74	44	34	**43**
29. Bulgaria	25	79	38	46	39	46	**46**
30. Romania	24	74	47	48	45	50	**48**
31. Greece	18	65	30	100	42	45	**50**

Source: Updated version of a table produced for Martin Marcussen, "The Lisbon Process and Economic Reform: Learning by Benchmarking"? in *The Euro at 10. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 87–110 (Oxford: Oxford University Press, 2008).

that was broadly expected prior to its realisation. Paradoxically, the financial crisis of 2008–2009 has created the foundation for some degree of convergence with regard to low growth and high unemployment in the Euro area. In addition to these macro-economic fundamentals, economic differentiation is clearly illustrated when focusing on the institutional capacity of the Euro-insiders to generate innovation and a competitive business environment. On all issues related to the Lisbon process, the Euro-insiders seem to perform very differently.

Political differentiation

Another dimension of the EMU differentiation project concerns political differentiation. Whereas economic differentiation concerns processes that consolidate and sometimes maybe even increase differences with regard to economic performance, political differentiation has to do with aspirations, traditions, cultures and programmes regarding economic governance in Europe, and the extent to which the EMU may uncover existing and maybe even produce new cleavages among the member states.

An important dimension of this concerns the structures of different kinds of capitalism in Europe. Although many distinctions have been made in the literature, a common scheme of classification singles out an Anglo-Saxon model of capitalism – a liberal market economy – and a German-inspired model of capitalism – the coordinated market economy.[9] To this a model can be added that better encompasses the French model of capitalism – a so-called state-directed market economy.[10]

A basic feature of the *liberal market economy* concerns "coordination through competition". Market actors – sellers and buyers – interact on the basis of supply and demand and the consequent setting of product prices. The role of the state is to ensure that competition can take place freely. Great Britain is commonly taken to represent this type of capitalism in Europe. In contrast, a *coordinated market economy* is based on the idea that market actors interact on the basis of competition as well as on strategic considerations related to their involvement in close societal networks. Whereas actors in the liberal market economy act on an arms-length principle, buyers and sellers in a coordinated economy are involved in all kinds of institutionalised forums in which coordination, negotiation, deliberation and planning takes place. The role of the state is primarily to maintain and support that kind of economic negotiation among market actors.[11] In some variants, the German, ordo-liberal "Soziale Markwirtschaft"

9 Peter A. Hall and David Soskice, eds., *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).

10 John Zysman, *Governments, Markets, and Growth* (Oxford: Martin Robertson, 1983).

11 Kenneth Dyson, "Germany and the Euro: Redefining EMU, Handling Paradox, and Managing Uncertainty and Contingency", in *European States and the Euro. Europeanization, Variation, and Convergence*, ed. Kenneth Dyson, 173–211 (Oxford: Oxford University Press, 2002); Kenneth Dyson, "Germany: A Crisis of Leadership in the Euro Area", in *The Euro at 10. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 132–164 (Oxford: Oxford is at the centre of this model, in others, the Scandinavian welfare state model is the reference point. The *state-directed market economy* is again different from the two previous forms. In addition to fine-tuning market mechanisms (like in the liberal market economy) and facilitating social co-ordination (like in the coordinated market economy) the role of the state in the state-directed market economy is to spell out the rules of the game applied on the market place and to intervene with a view to counter-balance market failures. Here the colbertist regulatory tradition of France could serve as a proxy.[12]

Clearly, all three types are ideal-typical and in many ways a caricature of very complex, diverse and dynamic national models of capitalism in Europe. In addition, all three types have their flaws, "market failures" in the case of the liberal market economy, "network failures" in the case of the coordinated market economy and "state failures" in the case of the state-directed economy. By evoking these models at this stage it becomes clear that European monetary cooperation has been and continues to be characterised by *cooperation between countries with quite different political and indeed cultural traditions as regards the role of the state in the economy*. In contrast to many peoples' expectations, the supposedly largest step forward in European integration, the construction of the Economic and Monetary Union, has been taken despite these manifest political differences in the European economy.[13]

A number of different approaches have been applied to theoretically understand how this is possible in the first place. Scholars leaning towards neofunctionalism would point to political dynamics at the European level in terms of supranational leadership, business lobbyism and judicial activism. Scholars of the intergovernmental breed would direct their attention to strategic, geopolitical and functional considerations in major member states. The point of departure here, however, is that political differentiation has always been an integral element and a basic assumption of European economic integration. However, it could be argued that the EMU, rather than levelling out these political differences, reactivates and

University Press, 2008); Kenneth Dyson, "German Bundesbank: Europeanization and the Paradoxes of Power", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 131–160 (Oxford: Oxford University Press, 2009).

12 David Howarth, "The French State in the Euro-Zone: 'Modernization' and Legitimizing Dirigisme", in *European States and the Euro. Europeanization, Variation, and Convergence*, ed. Kenneth Dyson, 145–172 (Oxford: Oxford University Press, 2002); David Howarth, "France: The Political Management of Paradoxical Interests", in *The Euro at 10. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 111–131 (Oxford: Oxford University Press, 2008); David Howarth, "Bank of France: The Challenge of Escaping Politicization", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 111–130 (Oxford: Oxford University Press, 2009).

13 David Marsh, "France, Germany and Fissures in the Eurozone", *Financial Times*, January 11, 2009; David Marsh, *The Euro. The Politics of the New Global Currency* (New Heaven: Yale University Pres, 2009).

even accentuates differences between basic national traditions regarding the role of the state in the economy.

Thus a defining cleavage between Germany and France has concerned such differences as regards European economic structures and the definition of legitimate governance. France has always been in favour of leaving essentially political decisions to European political leaders, whereas post-war Germany has preferred to transfer competences over entire policy sectors to civil servants that are protected from the supervision of political leaders. The French prefer a high degree of *gouvernance économique*, meaning the institutionalisation of European political processes that would produce political leadership and direction. According to such a view it is not only possible to let European political elites influence the direction of European integration, it is also their duty and the essence of being elected as a politician. Legitimate political decisions are being made by elected politicians with popular mandates and not by unaccountable bureaucrats. In contrast, the Germans prefer governance structures characterised by a high degree of *institutionalised autonomy* and the specification of precise and one-dimensional policy-objectives to be pursued by neutral civil servants. Accordingly, important policy-areas need to be protected from so-called narrow-minded and short-sighted political leaders. Legitimate decision-making is based on expertise and evidence, and it does not take account of opportunistic political behaviour. It is apolitical and almost scientific in its approach.[14]

These differences are being built into the governance structure of the Economic and Monetary Union. In line with the German ideal, the European Central Bank is the most autonomous central bank ever seen and it pursues one, and only one, objective: price stability for the Euro area over the medium term. It would take a revision of the Treaty of the European Union to alter the institutional status of the ECB. In line with the French ideal a complex set of political forums of coordination has been established, such as the Eurogroup, the Eurogroup working group under the economic and financial committee, and, as we shall see below, a Euro-summit involving the heads of state and government of the Euro-insiders is in the making. Gradually these political forums have been formalised and regularised, and they constitute the most important scenes for economic coordination in Europe.

On an everyday basis, the Euro area can live with these differences in political perspective. It is during periods of crisis that they occur as cleavages that are hard to overcome and which underline the importance of political differentiation in the EMU. The financial crisis of 2008–2009 is just such an example of a situation in which the fundamental political cleavages are activated.

It took until September 2008 before European politicians reacted to the crisis. Until then, the Europeans seemed to be mostly concerned with

14 Martin Marcussen, "'Scientization' of Central Banking: The Politics of A-Politicization", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 373–390 (Oxford: Oxford University Press, 2009).

blaming American-style capitalism for the financial misery and claiming the superiority of the European way of capitalism. The German finance minister, Peer Steinbrück, told the German Bundestag that the US would soon be finished as an economic superpower and that it should show more humility.[15] However, by the end of September 2008, the Europeans started to reflect on the situation. The French President and acting president of the European Union, Nicolas Sarkozy, called on world leaders to hold a summit aimed at rebuilding a "regulated capitalism".[16] "The idea of an all-powerful market without any rules and political intervention is mad", Sarkozy claimed. "Self-regulation is finished. Laissez-faire is finished. The all-powerful market that is always right is finished [...]. We have to have a new balance between the state and the market", he said.[17] The German finance minister agreed, stating that laissez faire was "as simplistic as it was dangerous."[18]

If the Germans and the French agreed in their criticism of the American model, they were unable to communicate about a distinct European approach to the crisis. Sarkozy went on to argue that the European Union would need a stronger governance structure to be able to effectively respond to a crisis.[19] He also called for a global crisis summit. For that purpose he convened a so-called Euro-summit at the level of the heads of state and government from the countries that had introduced the Euro, including Gordon Brown.[20] The major purpose was to formulate the building blocks of a new financial order, a so-called Bretton Woods II.[21] However, for the Germans there were several flaws in the plan. One of the most serious was that they did not like the idea of Sarkozy using the financial crisis as a platform for establishing a new European governance structure. They considered the attempt of replacing the Eurogroup with a Euro-summit as an attempted coup d'état.[22] In a speech to the European Parliament Sarkozy defended the Euro-summit as a primary forum for European economic governance: "Meetings of finance ministers are not equal to the seriousness of the crisis. Does anyone think that finance ministers could have made available 1.800 billion Euro?" he asked the parliament. "Only heads of state and government could have done that". He went even further: "The Euro area must have a clearly identified economic

15 Wolfgang Münchau, "Paulson's Problem Presents Lessons for Us All", *Financial Times*, September 28, 2008.

16 *Financial Times*, September 24, 2008.

17 *Financial Times*, September 25, 2008.

18 Michael Skapinker, "Do Not Write off New York and London", *Financial Times*, September 29, 2008; *The Economist*, October 4, 2008.

19 *Financial Times*, September 25, 2008.

20 Tony Barber, "Sarkozy Calls for a Global Crisis Summit", *Financial Times*, September 29, 2008.

21 Gideon Rachman, "Super-Sarko's Plans for the World", *Financial Times*, October 20, 2008.

22 Wolfgang Münchau, "Sarkozy's Attempted EU Coup Fails – for Now", *Financial Times*, October 26, 2008.

government".[23] Such ideas about a European gouvernance économique were clearly not acceptable to the Germans, who feared an infringement of the autonomous status of the European Central Bank. "For us, it is very important that there be no suspicion around the establishment of a European economic government", said German finance minister Peer Steinbrück.[24]

The Germans were also unhappy with Sarkozy's plans for a European rescue fund amounting to 300 billion Euros. Angela Merkel and Peer Steinbrück would have none of it.[25] Soon, the Commission proposed its own plan regarding coordinated fiscal stimulus across the European Union worth 200 billion Euros.[26] The UK agreed to such a European initiative but the German Chancellor was obviously hesitant, with her minister of finance referring to his European colleagues as "lemmings" hurrying down the path to mass suicide[27] while criticising Gordon Brown of pursuing "crass Keynesianism."[28] And so it goes on, clearly exhibiting the differences in political perspectives about the role of the state in the economy and the extent to which major economic decisions should be taken at European or national levels.

In summary, political differentiation has always been an integral element of the EMU and its set-up reflects this fact. Occasionally, for instance during the financial crisis of 2008–2009, the basic political cleavages are exposed for everybody to observe and even inflated to an extent which may prevent the formulation of a coherent European response to the crisis.

Institutional differentiation

Institutional differentiation concerns the various ways in which EU member states are integrated in the decision-making structure of the EU. An obvious distinction can be made between the formal letter of the treaty texts and the so-called living constitution of the EU.[29] Procedures and structures as they are described in legal texts may not correspond to everyday decision-making practices that tend to be informal, multi-level and elusive in character.[30] Both aspects need to be taken into account when evaluating the extent to which different EU-states are involved in the European economic governance structure.

23 *Agence Europe*, no. 9771, October 29, 2008.
24 *Agence Europe*, no. 9775, November 5, 2008.
25 *Financial Times*, November 25, 2008.
26 *The Economist*, November 29, 2008.
27 Tony Barber, "Split Widens over Europe Recovery Plan", *Financial Times*, December 1, 2008.
28 *Financial Times*, December 11, 2008.
29 Gaby Umbach and Wolfgang Wessels, "Differentiation in the European System of Central Banks: Circles, Core, and Directoire", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 53–72 (Oxford: Oxford University Press, 2009).
30 Kenneth Dyson, *Elusive Union. The Process of Economic and Monetary Union in Europe* (London: Longman, 1994).

One dimension, of course, concerns the institutional differentiation that exists between Euro-outsiders and Euro-insiders.[31] The *informal aspect* of this is most clearly reflected in the creation and work of the Eurogroup. Prior to the creation of the Eurogroup, Great Britain, Denmark, Sweden, Greece and Italy expressed considerable concern that they would be excluded from an important decision-making forum and that such an introverted new forum would make the Ecofin Council merely a rubberstamp institution.[32] These countries gave express reservations, explaining that this body should not see the light of day or, failing this, that they should be involved in it.[33]

At an Ecofin Council meeting, the Belgian finance minister Philippe Maystadt stated that provisions should be "taken to ensure that the creation of an informal body does not become a factor of division between the countries of the Eurozone and those that will not (yet) be taking part". He stressed that the basic principle would be that the Ecofin Council would remain the only body empowered to take decisions. The acting president of the EU, Luxembourg Prime Minister Jean-Claude Juncker, confirmed this at a press conference saying that "the centre piece will be Ecofin". Furthermore, he felt that the "out" countries or the "pre-in" countries should be involved to a certain extent in the work of this informal body. Concretely, he presented three possible ways of attaining this: i) The Ecofin Council would be kept informed of the results of meetings through an oral report by a minister that has taken part in the work of the informal body; ii) The "out" countries could take part in certain meetings of this informal body as observers. In order to follow this track, it would, however, be appropriate to "give more reflection to the criteria to be retained to allow a country to be invited to take part or not". According to Philippe Maystadt, "participation in the new exchange rate mechanism could be one of these criteria"; iii) The "countries that could be considered as 'pre-in'" should be immediately involved in discussions within the informal body, primarily because they have officially shown their intention to rejoin the monetary Union in time. The monetary committee which was charged with preparing for the future Eurogroup should, in this spirit, reflect upon the arrangements for defining 'pre-in' countries.

The French minister of finance, Dominique Strauss-Kahn, who had originally proposed this new forum as an element in a European gouvernance économique proposed that two groups of Euro-outsiders should be "kept informed in a particular manner": a) member states not belonging to

31 Charles Goodhart, "Bank of England: Learning to Live with the Euro", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 241–262 (Oxford: Oxford University Press, 2009); Johannes Lindvall, "Sweden: Stability without Europe", in *The Euro at 10. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 307–323 (Oxford: Oxford University Press, 2008); Martin Marcussen, "Denmark and Sweden: Networking by Euro-Outsiders", in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 263–286 (Oxford: Oxford University Press, 2009b).

32 *Agence Europe*, no. 7058, September 15, 1997.

33 *Agence Europe*, no. 7101, November 17, 1997.

the Eurozone but which "fulfil all the criteria, including that of taking part in the exchange mechanism"; b) member states which, although not in the new exchange mechanism, have solemnly announced their intention (in particular by a vote in their legislative assembly) to "rejoin the Euro."[34]

Prior to the Luxembourg summit in December 1997 in which the Eurogroup was founded, Commission president Jacques Santer claimed that everyone agreed that the Ecofin Council "must remain the privileged forum for the reinforcement of economic coordination". He also said that he had no objection to the German minister of finance Theodor Waigel's idea of enabling the "pre-ins" (and the "outs", he added) to participate in the work of this informal body as observers.[35] At the end of the summit, the British Prime Minister Tony Blair emphasised that London refused a body that would be rival to the Ecofin Council and he proposed that the role of the latter should be clearly reaffirmed. He also pressed for the Euro-outsiders to have the right to take part, if they so wished, in the work of the new informal body.[36]

Looking back at how things really developed, it is clear that the Eurogroup has been de-facto formalised and it is increasingly rendering the Ecofin Council a parallel meeting forum and, some would argue, even a secondary meeting-forum. The formalisation of the Eurogroup has taken place gradually. In 2000, the Eurogroup started to meet prior to the Ecofin Council;[37] in 2003, a special preparatory group under the economic and financial committee was established. It was called the Eurogroup working group;[38] in 2004, it was decided that the Eurogroup should have its own permanent chairman;[39] and, in 2008, it was formally declared in the Lisbon treaty that the Eurogroup is an informal body. The Euro-outsiders do not receive any kind of background documentation for the meetings taking place in the Eurogroup and they are not participating as observers. Today we also know that the group increasingly makes de-facto decisions that are merely being confirmed in the Ecofin Council.

The more *formal aspect* of institutional differentiation can also be clearly seen by studying the EMU. One dimension of this is, of course, the institutionalised asymmetry between monetary policy-making that is being fully formulated at the level of the supranational ECB and issues related to fiscal policy which are prepared and implemented at the decentral and intergovernmental level of the European economic governance structure.[40]

34 *Agence Europe*, no. 7101, November 17, 1997.

35 *Agence Europe*, no. 7118, December 11, 1997; no 7119, December 12, 1997.

36 *Agence Europe*, no. 7120, December 13, 1997.

37 *Agence Europe*, no. 7760, July 18, 2000.

38 Ed Crooks and George Parker, "Single Currency Forum Freezes out non-euro states", *Financial Times*, April 29, 2003.

39 *Agence Europe*, no. 8783, September 11, 2004.

40 Gaby Umbach and Wolfgang Wessels, "The Changing European Context of Economic and Monetary Union: 'Deepening', 'Widening', and Stability", in *The Euro at 10. Europeanization, Power, and Convergence*, ed. Kenneth Dyson, 54–68 (Oxford: Oxford University Press, 2008).

Another dimension concerns the voting rules of the ECB Governing Council.[41] With fifteen EU member states in the Governing Council, each member has one vote. However, as a direct consequence of the ongoing enlargement of the Euro area, new voting modalities will be introduced at some point in the future.

Prior to the 2004 enlargement of the EU, the heads of state and government introduced a section in the Nice treaty enabling a modification of the decision-making procedures of the Governing Council of the ECB. This was an opening that was immediately seized by the ECB. Thus, immediately after the ratification of the Nice treaty, the ECB presented a proposal about how a system of rotating voting rights in the Governing Council could work in praxis. The ECB proposal was unanimously adopted at the European Council summit in spring 2003, and entered into force on 1 January 2004.

Concretely, the ECB suggested that the Executive Board should have a permanent seat in the Governing Council, and that a number of country groups should be established within which the countries in the same category should vote in turns. When the number of Governing Council members exceeded 15, the new voting modalities could be introduced, first with two country groupings and, when the number of governing council members reached 22, then with three country groupings. The first country group will be constituted by the five largest member states, sharing four votes. The second country group would be constituted by half of all the Euro-countries. They should share eight votes. Finally, the third country group would be constituted by the residual countries, sharing three votes. Within each group, each country should share their voting rights equally.

In praxis this would mean that in a Euro area constituted by 27 Euro-insiders, each member of the first country group, the largest Euro-insiders, will be able to vote on 80 percent of the issues on the agenda. In the second group, the medium-sized countries will be able to vote on 57 percent of the issues. Finally, in the third group, the smallest Euro-countries will be able to vote on 38 percent of the issues on the agenda. In preparation of the enlargement of the Euro area with Slovakia on 1 January 2009, the Governing Council of the ECB decided that the envisioned rotation system should be applied once the number of Governors exceeds 18.[42]

Thus, this represents an example of formal institutional differentiation between the Euro-insiders. How voting behaviour will look like in praxis remains to be seen. Due to the closed nature of the ECB regarding procedural issues related to the Governing Council we know very little about the extent to which voting actually takes place or whether consensual modes of decision-making have evolved.

41 Gaby Umbach and Wolfgang Wessels, “Differentiation in the European System of Central Banks: Circles, Core, and Directoire”, in *Central Banks in the Age of the Euro. Europeanization, Convergence and Power*, eds. Kenneth Dyson and Martin Marcussen, 53–72 (Oxford: Oxford University Press, 2009).

42 ECB press release December 18, 2008.

In summary, at both the formal and informal level of analysis, the EMU is characterised by institutional differentiation. This concerns the relationship between the Euro-insiders and the Euro-outsiders as well as the relationship between the Euro-insiders themselves.

Differentiation as the grundnorm

It seems as if a case could be made that differentiation is not an exception but rather an essential feature of European economic governance. Differentiation has economic, political as well as institutional dimensions. It has not disappeared as a result of the EMU, rather, it has remained in place and even in some regards been further elaborated and consolidated.

Just as full harmonisation and convergence would be very useful but also very dysfunctional in many respects, there are good and bad things to be said about the EMU as a differentiation project. It is clear that differentiation allows for flexibility in day-to-day work. The larger the Eurozone, the larger the possibility for decision-making deadlock if decision-making remains based on an idea about one vote for each Governing Council member. Institutional differentiation would allow for increased decision-making efficiency. Also, the fact that the Euro-outsiders have in practice not been allowed to participate in Eurogroup work has probably contributed to a development of a certain spirit of communality between the Euro-insiders.[43]

On the other hand, this chapter has pointed to a number of economic and political tensions among the Euro-insiders that may destabilise the cohesion of the Euro area. The economic tensions refer to the fact that the expected synchronisation of business cycles has not taken place, that economic performance is highly divergent and that the incentives for structural reforms within the Euro area seem to be small. Recently, the Commission has concluded that "the political incentives to pursue rigorous reform in the EMU are comparatively weak."[44] Belonging to the Euro area has, in some cases, even had an anaesthetising effect, the Commission says, noting that reforms have been less pronounced in the Euro area than in the rest of the EU. Feeling protected by the fact that they belong to this single monetary whole, Euro-insiders have sometimes not made the effort needed, the Commission explains.[45] Thus, on many levels "Europe's monetary union has produced 'predominately favourable' economic effects but it has also shielded countries from painful yet necessary structural adjustments and reforms, according to the European Commission."[46]

43 Uwe Puetter, *The Eurogroup. How a Secretive Circle of Finance Ministers Shape European Economic Governance* (Manchester: Manchester University Press, 2006).
44 Commission of the European Communities, "EMU@10. Successes and Challenges After Ten Years of Economic and Monetary Union", *European Economy*, 2/2008, (Brussels: DG Economic and Financial Affairs, 2008), p. 91.
45 *Agence Europe*, no. 9656, May 7, 2008.
46 Ralph Atkins, "Mixed reviews greet 10th anniversary", *Financial Times*, May 8, 2008.

For the Euro-outsiders, the realisation that the EMU might be considered a differentiation project rather than a harmonisation project would entail that their special situation would be normalised. Thus, the Exchange Rate Mechanism II (ERM II) has so far primarily been considered a "waiting room" for the pre-ins. It has never been contemplated as a permanent structure of the European system of economic governance. With new eyes on the economic, political and institutional dynamics of the EMU we would rather expect that the ERM II could constitute one out of many different concentric circles around the core of EMU. It would be one that eventually could host previous Euro-insiders that are unable to keep up with the speed of the core of EMU, and it could constitute a room to which Euro-outsiders could enter or leave as seems fit for their immediate needs. Thus, recognising the real economic, political and institutional developments of EMU would allow us to better grasp what kind of new project this really is and in which direction it may be developing.

For the EU as such, the case of the EMU may be an illustrative template for how it is possible to study the broader integration project as it deepens and widens. The founding fathers of the EU have been tempted to regard patterns of variable geometry, multi-speed and à la carte as temporary and essentially unwanted. Today, with an increasing number of different policy sectors included in the larger project, with still more members, and with an increasingly complex institutional and procedural configuration, we may be better served if we started to develop theory that was able to account for a transformed European polity characterised by differentiation.

Governing the Euro Area in the Next Decade: Assessment and Challenges Ahead

*Werner Ebert and Christian Kastrop**

Abstract

Against the background of the economic crisis the paper examines how the EMU has worked after ten years and which lessons can be learnt from the past. The paper develops ideas for the governance of the Euro area in the next decade and favours sound, sustainable and growth enhancing public finances, a strengthened structural policy coordination between Euro area members and a clearer surveillance of macroeconomic imbalances in a coherent institutional setting. In that respect the (Post) Lisbon Strategy is to be translated into the Euro area and a systematic competitiveness review should be implemented. In addition, a better coordination in an international setting and a deeper dialogue on the macroeconomic policy-mix are proposed.

Introduction

The EU has been hit hard by a severe global financial and economic crisis. Feedback loops between the financial markets and the real economy are still a major uncertainty with a potential to further aggravate the economic situation despite some positive looking frontrunning indicators. Markets remain volatile and credit channels are not yet functioning properly. Besides that, the EU and the Euro area in particular are confronted with the impact of the crisis on potential growth and the challenges for sustainable public finances. Even if there are less stormy times in sight, these three elements together also pose some risks on the coherence of the EU. The Eurozone, still facing major macro- and microeconomic imbalances, is even more affected as monetary policy is not individual and the exchange rate mechanism is missing.

A swift and credible reversal of the monetary and fiscal expansion conditioned on a sustainable economic upturn has to be ensured. The Stability and Growth Pact (SGP) can in principle provide the framework for a coordinated fiscal consolidation strategy to maintain sustainable public finances (fiscal exit strategy). However, the SGP was not designed for such a situation and there is an open question of how to deal with the corrective arm of the pact in cases where the current deficit significantly exceeds the

* The authors thank the participants of the panel “Governing the Eurozone in the next decade” of a conference hosted by the “Stiftung Wissenschaft und Politik”, 16 December 2008 in Berlin, for a fruitful discussion. We are also indebted to William Brunton, Birgit Mattil, Henning Roehreke, Angela Schneider and Xiong Hou for inspiring discussions on this topic and also for helping drafting the paper. The ideas presented in this paper reflect our personal views.

3 percent ceiling for a long period of time. It is also a question of governance whether this could be dealt within existing secondary law and proceedings or whether some new law or interpretation might be necessary.

The EU and the Eurozone have brought some coherence of policies but there is more to be done, especially on the microeconomic side. Countries facing strong macroeconomic tensions and large imbalances have to address the underlying structural problems and need to take sufficiently ambitious steps now to consolidate public finances. However, the different starting positions of the countries should be taken into account. The improvement of long-term sustainability is evermore challenging given the risk of declining growth potential and rising debt levels. With structural reforms in the private and public sector, the quality of public finances including strong national fiscal frameworks gain importance with respect to the formulation of a comprehensive exit strategy.

The current situation contrasts somehow with the widely held view that, a decade after the introduction of the Euro, the single currency has been positively contributing to macroeconomic stability and helping Member States weather economic storms. Nevertheless, the crisis revealed immanent problems of the Euro area, in particular persistent divergences in competitiveness and current accounts. Even if these problems did not cause the crisis, they have aggravated its impact. Other challenges such as the accession of eastern European countries in the Eurozone add to this. Given the substantial spill-overs and interactions, it is reasonable to assume that a better coordination within the Euro area to meet these challenges could provide further synergies to the EMU and would help Members to increase their resilience against economic shocks.

Against this background the paper – taking account of national responsibilities and the subsidiarity principle – assesses the record of the EMU from the view of a new perspective, identifies structural/governance shortcomings in order to develop a vision of an enhanced structural policy agenda for the EMU. In a second section, we will highlight the possibilities of enhancing the co-ordination between Euro area governments at a time suitable for implementing institutional changes for the next decade.

Assessment of the first ten years of EMU and challenges ahead

The constitution of the European Monetary Union set up by the Maastricht Treaty in 1992 aimed at ensuring the functioning of a common European monetary policy. In May 1998, the final stage of EMU was implemented and on 1 January 1999 the Euro became the official currency in eleven EU Member States, and thus the so-called Eurozone came into place (1 January 2002 signalled the Euro cash changeover). Until now, 17 EU Member States have joined the common currency area.

It is well known that the governance structure of the EMU is fundamentally characterised by the following aspects:

i) a monetary policy of the participating countries (Eurozone) which is entrusted to an independent European Central Bank (ECB);

ii) economic and fiscal policies are coordinated to different degrees between the Member States and at the European level by the Council (Ecofin).

From the very beginning of the common currency union some issues have been raised, e.g. has the defined work share between the institutions contributed to macroeconomic stability and growth? Has the resilience of the Euro area improved? Have macroeconomic imbalances been reduced and have the underlying structural problems been resolved? These questions have become even more urgent as the crisis continues.

Macroeconomic performance – impact of the financial and economic crisis

A first look at the macroeconomic indicators in the recent COM autumn forecast[1] reveals that economic growth in Europe and in the Euro area has dropped dramatically and unemployment rates are expected to rise sharply in most Members States in 2009 and 2010. The average Member States' budget deficit is projected to reach more than 4 percent of GDP in 2009, the highest level in 15 years, while peaks already reach or even go above 10 percent in Greece, Ireland, the UK and France. On the other hand, energy costs are still low and diminishing inflationary pressures improve consumer purchasing power leaving room for manoeuvre for macroeconomic policies. These key indicators give the impression that, whilst the inflation target has been met, other macroeconomic aggregates show clear room for improvement in the current juncture.

However, when assessing the contribution of the Euro to overall performance, one also has to consider the long-term figures. An assessment of the first ten years clearly shows a substantial improvement of the economic trend after the final implementation of the EMU in 1999.[2] Major progress can be seen in the decisively lowered inflation rates at an aggregate level compared to previous decades and to the US. In a ten-year comparison inflation dropped on average from 3.3 percent (89–98) to slightly more than 2 percent (99–08), whereas U.S inflation remained at an average of 2.8 percent.

The Euro area achieved massive growth in employment with around 17 million additional employees by the end of 2008 and an unemployment rate falling from 10.1 percent in 1998 to 7.5 percent in 2008. A stability-oriented macroeconomic framework has contributed to a reduction and convergence of interest rates and price volatility among the Eurozone

1 European Commission, "Economic Forecast Autumn 2009", *European Economy 11*/2009 (Brussels, 2009).

2 European Central Bank, "10th Anniversary of the ECB", *Monthly Bulletin* (Frankfurt, April 2008); Paul van den Noord, AlessandroTurrini, and Michael Thiel, "EMU@10 – Assessment, Challenges Ahead, Policies and Governance", *European Economic Research Letter* (European Commission, DG ECFIN) 2, issue 2 (Brussels, 2008); European Commission, "EMU@10: Successes and Challenges after Ten Years of Economic and Monetary Union", *European Economy* 2/2008 (Brussels 2008).

members. The fiscal framework of the European Stability and Growth Pact (supported by the Lisbon framework) has led to more budgetary discipline and long-term fiscal sustainability.

The negative side of the medal shows a significant (labour) productivity slowdown, with productivity growth dropping from 1.5 percent in 1989–1998 to an estimated 0.75 percent in 1998–2008. This contrasts with rapid productivity growth in the US and in non Euro area countries. This is one among many reasons why the growth performance of the Euro area remains moderate and, in comparison to the preceding decade, unchanged at a rate of around 2 percent p.a.

Despite the impact of the current crisis, it can be stated that the common currency area has shown a better resilience against economic shocks, particularly in the labour market. Whereas in the past we faced slower recoveries from economic downturns than in the US and in that respect a lack of resilience, Euro area performance has gradually improved and it experiences smoother global cycles, a fact which might be attributed to the disappearance of intra-area exchange rate realignments and a stability-oriented macroeconomic policy framework. Nevertheless, business cycles between participating countries have not become more synchronised than fluctuations between the Euro area and the rest of the world.

In addition, macroeconomic imbalances are a major problem. Until now there has not been a substantive change in the divergences of growth and inflation rates within the Euro area. Some countries clearly have not done their microeconomic homework – in the crises this may lead to a dangerous structural development.

Financial integration between the countries of the Euro area has generated overall benefits – with substantially more benefits for larger than for smaller members. The introduction of one single and stable European currency contributed to increasing liquidity and enhanced the exchange in credit and capital markets for foreign investors and borrowers. Despite the public criticism at the beginning of the EMU, the Euro since 1999 has shown an impressive resistance against exchange rate fluctuations against the US Dollar and the Yen. The EMU contains a stabilising function which goes hand in hand with the improved resilience against economic downturns.

Nevertheless, the international monetary system is still dominated by the US Dollar as the European currency has still not reached sufficient international representation.[3] This may in institutional terms be attributed to a lack of international coordination and a lack of cohesive cooperation between the members of the currency union. On the other hand, it clearly reflects the national divergencies and starting positions, which hinder the establishment of a fully integrated currency area in a strict sense, e.g. in terms of external representation. In sum, there is ample room to strengthen the Euro as the European common currency and underline

3 See the discussion in Jean Pisani-Ferry and Adam Posen, eds., *The Euro at Ten: The Next Global Currency* (Brussels: Bruegel and Petersen Institute for International Economics, 2009).

its economic and structural benefits to all citizens in the Euro area by triggering more homogeneity in that area. The Renminbi link to the US-Dollar at present leads to adverse effects when China is recovering fast and devaluating against the Euro.

Structural performance

In the early years of the Euro structural reforms have been pursued particularly in the context of the Lisbon Strategy starting in the year 2000. However, reform efforts decreased in the following years particularly in the larger nations but also in some of the smaller countries of the Euro area. The unfinished structural reform agenda and the still lagging productivity and potential growth performance in relation to the US led to the renewal of the Lisbon strategy with a somewhat more pronounced focus on the Euro area. The new Lisbon agenda will resume next year and lessons learnt from the crises must be taken on board.

The single currency itself had little effect on the pace of structural reforms. Slight improvements in cross-border integration of goods and services were accompanied by severe backlogs of the internal market within the Euro area. Price rigidities persist and the gap between robust and vulnerable members continues to widen. Some Member States have not been able to overcome the political difficulties in tackling microeconomic problems. Certain other members have so far resisted any EU-driven intervention in the microeconomic functioning of their economic systems even in the form of weak policy checks and coordination. Microeconomic sovereignty is now the flag held up against new mechanisms for coordination, even if this leads to the underperformance of the Eurozone as a whole. All this has weakened the incentive for structural reform, although the need to adapt becomes increasingly important in the current juncture of financial turmoil and political insecurity.

In sum, the structural side of the Eurozone framework remains weak. The role of the structural reform agenda and its implementation within the Euro area is still conceptually and institutionally vague, not even systematic. The Lisbon agenda 2000 is still not working properly in that field. Due to these past failures the members cannot sufficiently address the current challenges by acting as a whole in a coherent manner. The present situation allows them to act without rethinking the common consequences of political quarrel, disagreement and solo-performances for the Euro area as a whole (economic and political spill-overs) – even if a cooperative game would most probably be a win-win situation for every Member.

Long-term challenges ahead

While celebrating a largely successful 10th anniversary of the EMU new challenges and trends are emerging on the horizon. There are two essential branches where major challenges are materialising.

One of the most important implications for the Euro area is globalisation which affects Member States in two opposite ways: facing the growth of low-wage emerging markets and rapidly changing global terms of trade. Arising global imbalances have to be counteracted by adjusting efficient measures in the intra-Euro area, by promoting productivity, potential growth and jobs, improving the quality and sustainability of public finances (also against the demographic challenge) and securing a careful enlargement strategy.

Even if the crisis has shifted our attention, Member States will have to deal with climate change and scarce natural resources. The impact on commodity and energy markets puts severe challenges to the Euro area members in the future. Higher inflation rates and changes in relative prices caused by fluctuating commodity markets and climate changes have to be counteracted by amending the current monetary policy.

One further important challenge is the Euro area enlargement.[4] During the next decade in particular eastern European countries will join the European Monetary Union. The common currency area will continue its expansion and has to realise an increasing demand for coordination. Therefore, it is necessary to develop adequate policy rules and suitable European and international coordination.

Political and institutional lessons for the Eurozone

Sound, sustainable and growth-enhancing public finances in the Euro area

Although fiscal discipline in the Euro area was largely on track before the crisis[5], the long-term branch of fiscal discipline, i.e. meeting the demographic challenges, needs to be addressed. The rapid aging of European citizens remains a severe challenge for long-term sustainability of public budgets and social security systems. Euro area members have to think about necessary adjustments, mainly with regard to structural changes, such as labour market policy, internal market issues, mechanisms for national pension funds and the need to strengthen public finances with respect to age-related expenditure pressures.

Due to the worldwide financial turmoil and its economic effects the interruption of fiscal consolidation may also be dangerous in structural terms. The fiscal and structural packages,[6] devoted to stimulating the

4 Ian Begg, "Economic Governance in an Enlarged Euro Area", *Economic Paper* (European Commission, DG ECFIN) 311 (Brussels, 2008).

5 Despite quite some irritations caused by Germany and France which in the end led to a successful more pragmatic reformulation of the Pact including the strengthening of its preventive arm. For the recent resurgence up of the debate on the role of the Pact in the current crisis caused by France see "Paris will Staatsdefizite schönrechnen", *Financial Times Deutschland,* June 2. 2009, 11.

6 COM has undertaken a comprehensive assessment the national recovery packages together with the Ecofin Council.

troubled economies, may impose an unsustainable burden on national budgets and it is hardly conceivable to keep fiscal discipline on track if these policies are not accompanied by a countervailing long-term strategy. As an example, the discussion in Germany links the fiscal recovery package with a commitment to a new deficit rule, the so-called "debt brake".[7]

In structural terms, the qualitative side of fiscal policy – the "quality of public finance" approach – is still an emerging discipline: concrete political conclusions by ministers have not yet been drawn and strong commitments are to be awaited.[8] Besides the stability-orientation, a major challenge will be to assess and improve the growth-orientation of public finances as new module of the reformed Pact. In principle the platform to integrate quality of public finance into the framework is already designed; however a sufficient implementationby Euro area members is still lacking. Quality of public finance has the potential to be a very strong tool as part of necessary exit-strategies out of the crisis. Governments need to pursue a growth-enhancing composition of public expenditure and adapt tax structures in an efficient manner. It is indispensable to incorporate the economic dimensions of effectiveness and efficiency in the assessments of Stability and Convergence Programmes as indicator-based benchmarks with respect to the new rules of the reformed Pact. Independent institutions would then have supervisory roles and give directions to political and economic actions.

Translating the Lisbon Strategy into the Euro area[9]

The overall framework for coordinating economic policies of EU Member States and of Euro area members is the Lisbon Strategy. It basically consists of the Integrated Guidelines, National Reform Programmes and a complex but still weak multilateral surveillance process. The economic policy coordination is dealt with along the lines of Article 99 of the old Treaty including the monitoring of economic developments on the basis of reports by the European Commission.

Since the Lisbon Mid-Term Review in 2005, the Euro area has been explicitly incorporated as a collective member, monitored itself and guided by specific recommendations. The Eurogroup agrees on policy guidelines and recommendations that apply specifically to the Euro area. Country-specific recommendations as one central tool of the Lisbon Strategy are not solely devoted to Member States of the now EU27 but also specifically to the Euro area and its members. These include the areas of competition and the functioning of the internal market. The assessment of the imple-

7 Christian Kastrop, Elke Baumann, and Elmar Doennebrink, "A Concept for a New Budget Rule for Germany", *CESifo Forum* 2/2008 (Berlin, 2008): 37–45.
8 Christian Kastrop and Servaas Deroose, eds., "The Quality of Public Finances", *Occasional Paper* (European Commission, DG ECFIN) 37 (Brussels 2008).
9 Werner Ebert and Christian Kastrop, "Lisbon Post 2010 – The Future of the Lisbon Strategy in the Context of the Current Crisis", *Wirtschaftspolitische Blätter (Sonderausgabe Schwerpunkt EU-Integration: Lissabon Post 2010)*, Vol. 56 (Wien, 2009): 99–108.

mentation of these specific recommendations has become a relevant part of the policy coordination process around the Integrated Guidelines.

Although many Member States include details in their response to the Euro area recommendations in their National Reform Programmes, these policy responses are not monitored explicitly. Throughout the year the Eurogroup holds ad hoc-discussions on selective aspects included in the Euro area recommendations. However, commitment to support structural reform efforts by national peer and public groups which put pressure on governments is missing in the Euro area setting. Against this background, there is a clear need to sharpen the setting for the economic policy discussion of the Integrated Guidelines for Growth and Jobs for the Euro area, particular when it comes to the structural policy aspects.

Coordination of the Eurozone in an international setting

Instead of improving international co-ordination, the EMU has actually made it more complicated. The international representation of European monetary and fiscal policies is still fragmented and will be even more so when the Eurozone enlarges. At meetings like G7, OECD or IMF the Euro area is represented by the Member States which keep their own seats and maintain their national interests. Some Eurozone countries are not members in such external organisations so that the European representation remains incomplete on the international stage. This situation makes it difficult to convey a single European voice on global economic and financial questions and complicates the intra-European communication.

Against this background one proposal to enhance the international co-ordination is to consolidate all Euro area members in a unique representation approved by the Eurogroup. One single European voice in multilateral organisations could strengthen its influence on economic and political matters. In that respect the Eurogroup is still to be completed as a generally accepted and efficient organ in the European Union.

Strengthening the Eurogroup in political and economic matters could also enhance the European co-ordination as an open forum. However, the Ecofin Council is still the formal body and main institutional actor for economic and financial policies in Europe; it is the political stage where all European finance ministers decide the essentials: fiscal policy, taxation and financial markets. The Ecofin also deals with the Lisbon Strategy and current questions, e.g. financial turmoil, high energy and commodity prices.

In contrast to that, the Eurogroup has no constitutional role for economic and fiscal policy-making, nevertheless it shapes outcomes for the Ecofin and allows a more open and frank discussion. The Eurogroup will remain the most influential European political forum when informal agreements become policy in the Ecofin.

Another issue is the composition of the group where finance ministers discuss economic matters. As many structural policies are horizontal ones, Heads of State could be involved in Eurogroup matters by shaping political agendas in specific policy areas or when it comes to an international context.[10] However, this should not allow for a weakening of finance ministers in defining the policy agenda. Preparing reforms of governance is the task of the two expert committees: the Economic and Financial Committee (EFC) and the Economic Policy Committee (EPC) in their respective Eurogroup composition. Both Committees work behind the scenes and prepare political discussions for Ecofin/Eurogroup. This institutional basis guarantees a sound economic foundation of EU finance ministers' proposals which would probably be abandoned if the format of finance minister responsibilities were to be substantially extended to or even replaced by Heads of State.

A competitiveness review for the Euro area

Taking up the assessment of the first ten years of the EMU and some of the weaknesses in the SGP and Lisbon context the EU Commission report EMU@10 made specific proposals on how to strengthen economic surveillance in the Euro area which were taken up by the Eurogroup. Ministers agreed on a broader coverage of surveillance including macroeconomic divergences between Member States and competitiveness developments in the form of a regular review of competitiveness divergences.

The design of such a review, comprising both horizontal and country-specific elements, can build on existing processes while reinforcing surveillance with regard to additionalrequirements. A proper competitiveness review has to pay special attention to the economic adjustment channels and mechanisms in the absence of individual monetary and exchange rate policies. Spill-overs from policy decisions, benefits and synergies from coordination, need to be taken into account in policy making. More in-depth and systematic surveillance among Euro area members showing unbalanced growth, large current account deficits and persistent inflation differentials could contribute to a prevention of overheating or long-lasting and costly structural adjustments. That would lead to a recovery incompetitiveness and would ensure that economic policies at the national levels are consistent and coherent. In order to improve effectiveness, a competitiveness review should build on the existing elaborated architecture and should avoid increasing complexity.

Such a review should focus on real effective exchange rates and their determinants as well as the consistency among national policies having direct implications for competitiveness. A comprehensive review as part of the macroeconomic and structural policy surveillance could enable Eurogroup Ministers to be systematically informed about strategies, choices and challenges outstanding in the individual Member States and the Euro area as a whole without creating new reporting procedures. Using the informal character of the Eurogroup, the review could provide the oppor-

10 The far-reaching French proposal of a "government economique" goes somewhat in that direction.

tunity to discuss in-depth policy issues relevant to the functioning of the EMU. The output could be a common understanding and compilation of targeted policy guidelines and recommendations in order to prevent entrenched and unwarranted divergences.

In fact, areas of concern in adjustment of the Euro area are real exchange rate developments, its determinants (persistent inflation differential, low productivity growth) and consequences, factors that affect the speed of adjustment (functioning goods, services and labour markets) and strategic conditions like current account positions or strategic sectors (services, housing). It will be crucial to identify the cross boarder spill-over effects of policy responses and to assess the "structural" role of the public sector (productivity of the public sector) and financial markets (impact of quicker reallocation of capital on the transmission of both monetary and fiscal policies and financial stability).

There is a clear link between competitiveness and the need to improve incentives for structural reform in line with the Lisbon Strategy. The role of the Eurogroup needs to be improved in these matters and the debate on recommendations within the Euro area dimension of the National Reform programmes needs to be deepened.

A framework for a Euro area macroeconomic dialogue

Another angle for improving Euro area co-ordination is the Macroeconomic Dialogue (MED).[11] Established by the June 1999 Cologne European Council it is a biyearly high level forum between the Council, the Commission, the European Central Bank and the Social Partners. The MED is set up to contribute to the growth- and stability-orientation of the macroeconomic framework in the EU. The Dialogue is based on the principle that key macroeconomic policy stakeholders and decision makers and those responsible for wage settlements should have a proper understanding of each other's positions in their respective responsibilities. Its purpose is to improve the interaction between wage developments and monetary and fiscal policies conducive to non-inflationary growth. An important feature is the strict confidentiality of the proceedings.

The organisation of the MED with its two-layer structure – political MEDPOL and technical MEDTEC – is a matter for the respective EU Presidency. For the MEDTEC the Economic Policy Committee sets the framework. The President of the EPC as moderator sets the agenda in agreement with the Council Presidency. In the past the MEDPOL was

11 For a general overview and assessment of the MED see Volker Hallwirth and Willi Koll, "Zehn Jahre Makroökonomischer Dialog – eine Zwischenbilanz", *Wirtschaftsdienst*, Vol. 89 (2009): 26ff., Gerhard Huemer, "10 Jahre Makroökonomischer Dialog in der Europäischen Union", *Wirtschaftspolitische Blätter (Sonderausgabe "Schwerpunkt EU-Integration: Lissabon Post 2010)*, Vol. 56 (Wien, 2009, forthcoming), and Andrew Watt, "The Coordination of Economic Policy in EMU – What Contribution Can the Macroeconomic Dialogue Make to Higher Growth and Employment?", in *Macro-economic Policy Coordination in Europe and the Role of the Trade Unions*, ETUI/WSI, 199ff. (2005).

criticised for running the risk of a decrease in attention. Participation of two Council formations, two Commissioners and a non-Euro area central bank leads to too many speakers and increases the likelihood of a dispersed debate.

Against this background, a framework is needed which tackles the basic macroeconomic issues, namely to prevent and diminish macroeconomic imbalances while avoiding the disadvantages of the MED in EU 27 composition. A Euro area MED could provide a platform and a high-level forum for an exchange of views between the Eurogroup, Commission, European Central Bank and the Social Partners. In order to allow for a fruitful exchange of views the number of people at the table should be strictly limited. An analytical platform under the stewardship of the EPC-Eurogroup could be in charge of technical preparations. While fully respecting the independence of the participating institutions and actors, a leaner and streamlined setting could contribute to the formulation of a coherent macro-economic and structural policy-mix. Bringing the MED closer to the Eurogroup could offer value-added over and above existing procedures in the context of the Cologne-process, exploit synergies, while avoiding overlay and duplication to the regular Eurogroup procedures. The economic crisis clearly shows how important the policy-decisions of the macroeconomic stakeholders are, and it offers a window of opportunity to test such a Euro-MED approach.

Outlook

This paper presented some ideas on further developing the governance of the Euro area in the next decade.[12]

Avenues to proceed may be the improvement of the macroeconomic coordination setting, particularly in the fiscal branch, concerning the macroeconomic dialogue and with respect to macroeconomic competitiveness issues.

Even in the present crisis it is becoming increasingly clear that the structural Lisbon side of economic policy coordination has become much more important within the Euro area in the long-run. The coordination and surveillance problems show ample room for substantial improvements, as new challenges emerge and imbalances have to be addressed.

A first institutional target can be seen in the further development of the Lisbon process which will come into place in the first half of 2010. The so-called Europe 2020-Agenda should indeed devote some time and substance to the improvement of Euro area governance.

12 See also Federal Ministry of Finance, “The EURO at Ten”, *Monthly Bulletin* (Berlin, January 2009): 56ff.

Financial Market Supervision: The Road ahead after de Larosière

*Karel Lannoo**

Abstract

Deep structural change is underway in EU financial supervision. Further to the decisions of the European Council of June 2009, a new framework is being implemented for EU financial supervision, as called for by the de Larosière Committee. The author outlines the challenges and pitfalls that the EU faces in developing the objectives, functions, organisation, governance and funding of essentially four new entities: a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS), comprising three functional authorities. Given that these ambitious measures come on top of other proposed initiatives resulting from G20 commitments and that they will have to be pushed through in a context of a new European Parliament and a new European Commission, he cautions against expecting a swift or easy decision process.

The decisions taken by the European Finance Ministers on 9 June 2009, and subsequently adopted by the European Council on the 18–19 June, broadly implement the proposals on European financial supervision put forward by the de Larosière Committee and the European Commission, and also provide the necessary detail. From 2010 onwards, a new structure should be in place to ensure more integrated European macro- and micro-prudential oversight. The macroeconomic body – the European Systemic Risk Board (ESRB) – will be consultative in nature and will largely function within the context of the ESCB (European System of Central Banks). Hence its practical implementation should not be too problematic. The different functional authorities coordinating micro-prudential supervision will be established by mid-2010, basically upgrading the existing Committees, but they will have a substantially increased workload, which raises important structural and organisational issues.

Apart from the adaptation of the institutional structure, the EU is currently implementing a comprehensive regulatory response to the crisis, following at the same time a globally dictated agenda pursued by the G20 and a set of 'single market' measures. The latter result from inconsistencies (e.g. deposit guarantee schemes) and gaps (e.g. mortgage credit) in the existing regulatory framework.

This ambitious workload coincides with important changes afoot on the EU scene, which could delay the legislative process. A new European Parliament is coming into office, and will take some time to get a grip on the dif-

* First published as *CEPS policy brief*, No. 195/August 7, 2009.

ferent dossiers. With more than 50 percent of the elected MEPs serving for the first time, a fast track of new legislation cannot be expected. In addition, a new college of European Commissioners was appointed by the end of 2009, and a new work programme adopted. Moreover, the implementation of the Lisbon Treaty by the end of the year will result in further seismic shifts. In short, the circumstances in the European Union are not especially favourable at the present time for adopting an enormous legislative agenda.

The de Larosière agenda

The Council of Finance (Ecofin) Ministers of 9 June 2009 agreed upon a new structure for supervision in the EU, consisting of essentially four new entities: a European Systemic Risk Board and a European System of Financial Supervisors (ESFS), comprising three functional authorities (see figure below, p. 64). The Council conclusions describe in much detail the framework and responsibilities of the new supervisory bodies. Implementation of either of these decisions, however, still raises problems: of a conceptual nature for the ESRB, and of a more organisational character for the ESFS.

The Ecofin Council stated in its conclusions that "regulation and supervision in Member States and in the EU must be enhanced in an ambitious way ensuring trust, efficiency, accountability and consistency with the allocation of responsibilities for financial stability, taking into account the responsibility of Finance Ministers."[1] Ministers probably wanted to recall earlier discussions in the Ecofin on financial supervision in 2002, and remind the public that, because of the accountability to taxpayers, they are in control.[2] The respect of fiscal sovereignty is further reiterated several times in the Council conclusions.

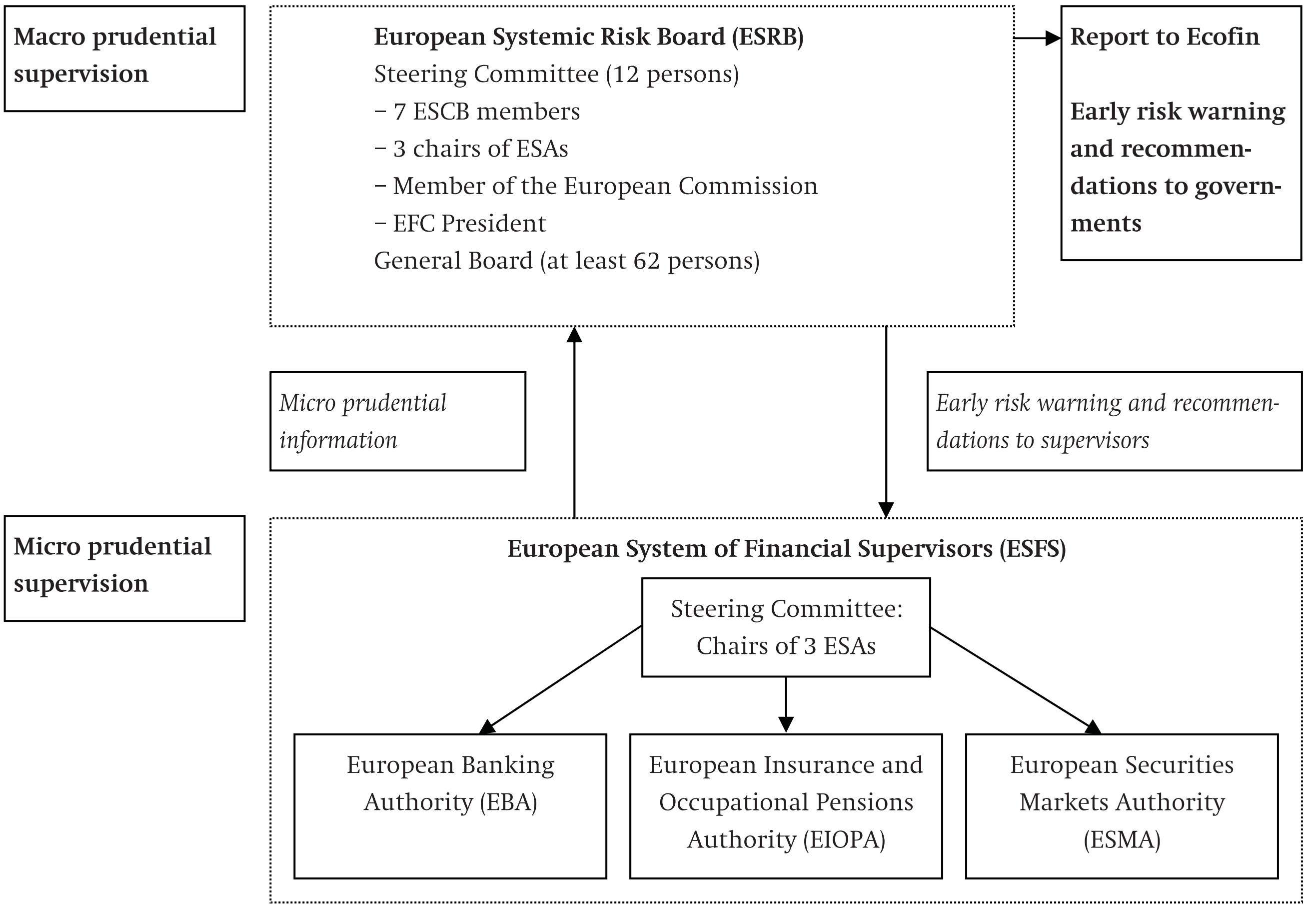
The European Systemic Risk Board (and the ECB) at the center

The ESRB will be at the centre of the new system, even if this body is only consultative. Its twelve-member Steering Committee is composed of the seven ESCB members (including the President of the ECB), the three chairs of the European Supervisory Authorities (ESAs), a member of the EU Commission and the President of the Economic and Financial Committee (EFC). The dominance of the central bankers in the governance of the new structure is even clearer in the General Board of the ESRB, which comprises, apart from the Steering Committee members, all central bank governors of the EU 27. The creation of the Steering Committee, not foreseen in the de Larosière report, probably responds to the criticism that the ESRB will be too unwieldy to be effective.

1 Council conclusions on strengthening EU financial supervision, Luxembourg, June 9, 2009.

2 See conclusions of the Ecofin Council of May 2002.

Figure 1
The new European supervisory structure



The ESRB will have its seat in the ECB and will rely on the analytical and administrative services and skills of this well-reputed and established institution. Thus it will also be controlled by the ECB. The Finance Ministers have only one representative in the ESRB. Hence, notwithstanding the declaration of the Finance Ministers that they want to be in the driver's seat, the power on top will reside with the central bankers.

The ECB had reacted against the establishment of the ESRB as a separate legal entity, which the European Commission initially proposed, and preferred the use of Article 105.6 of the EU Treaty to confer macro-prudential tasks to the ECB/ESCB. However, as the latter requires unanimity in the EU Council – and therefore seemed very improbable – the ECB preferred the former option, but functioning as a consultative body only.[3] In a confidential note on the Commission's working document on European financial

3 According to the Commission proposal, Article 105.6 will be used to allow the ECB to act as secretariat for the ESRB, see European Commission, "Proposal for a Council decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board", September 2009.

supervision,[4] it wrote: "The establishment of the ESRB as an EU body with legal personality would create a separate EU quasi-central banking institution with responsibilities that are overlapping with the financial stability tasks performed by the ECB/ESCB". It noted that a separate entity would become confusing and raise questions of representation and competence.

The ESRB should:

- define, identify and prioritise all macro-financial risks;
- issue risk warnings and give recommendations to policy-makers, supervisors and eventually to the public;
- monitor the follow-up of the risk warnings, and warn the EU Council in the event that the follow-up is found to be inappropriate;
- liaise with international and third country counterparts; and
- report at least bi-annually to the EU Council and European Parliament.

The ESRB will also strengthen the ECB's role in another sense. Through the ESRB, the ECB will have access to micro-prudential information. Throughout the financial crisis, ECB officials have criticised the lack of access to supervisory information of financial institutions. In its confidential memo to the Commission President, the ECB requested the right to collect supervisory information: "The ECB/ESCB should be provided with the task to collect and share macro-prudential and aggregated micro-prudential information [...] which is necessary for the performance of the tasks of the ESRB".[5] The Ecofin Council decided differently, however, stating that the "central European database should be established and managed by the European Supervisory Authorities." But this information should be shared with the ESRB "subject to specific confidentiality agreements", it was added.

Crisis management is not mentioned as a task of the ESRB, but of the ESFS in an exploratory way. This is a departure from the ad-hoc agreement reached in the European Council in October 2008, whereby the President of the ECB (in conjunction with the other European central banks) formed part of a financial crisis cell, with the President of the Commission, the EU Council and the Eurogroup.

The task is now essentially for the ECB to bring the ESRB into existence. Although the ESRB can depend on formidable back-office support from the ECB, it will face significant conceptual challenges. Will it be capable of clearly identifying and reacting to a bubble amongst the hundreds of possible risks on the horizon? Will it have sufficient authority and the necessary imagination to challenge conventional wisdom? Will the reporting tree function and the reaction be adequate? Will the boundary

4 European Central Bank, *The Establishment of the European Systemic Risk Council*, May 24, 2009.
5 Ibid., p. 4.

with the micro-financial tasks be drawn in an unambiguous way?[6] The ECB needs to realise that the responsibility it takes in assuming this task could negatively impact its reputation in the future, and eventually its independence in setting monetary policy.[7] Hence the ESRB should have sufficient independence from the ECB. Any further discussion on this subject, which is also taking place in the US with the proposed creation of a Financial Services Oversight Council (White House proposals), should proceed with extreme caution.[8] However, it seems that, because of these conceptual challenges and institutional issues, the European solution of creating a purely consultative body, separate from the central bank, finance ministers or supervisors, is the right step forward. It respects their respective roles on how to act upon the recommendations of the ESRB, and at the same time protects them from the consequences of erroneous warnings. In the composition, on the other hand, the ESRB is too much relying on the central bankers.

The European System of Financial Supervisors

The establishment of the ESFS is a daunting task. Unlike the ESRB, the authorities can hardly rely on an existing structure, but almost need to start from scratch, or need to magnify the tasks currently performed by the Committees to an exponential degree. It is for this reason (among others) that we recommended establishing these authorities under a single roof from the very beginning, in order to share as much as possible a common administration and avoid unnecessary duplication of effort and confusion of responsibilities. However, a single roof would have meant a single location, the selection of which would have opened a Pandora's box that the EU Council preferred to keep closed. Problems would inevitably

6 On the difficulties of macro-prudential regulation see Avinash Persaud, *Macro-prudential Regulation*, ECMI Commentary No. 25 (Brussels: European Capital Markets Institute, August 2009).

7 It should be recalled that the ECB already has a committee under its roof with responsibility for some of the functions expected of the ESRB. Its Banking Supervisory Committee (BSC) brings together banking supervisors of all the EU countries, and not only the Euro zone, to discuss macro-prudential and financial stability issues. In response to criticism on the lack of macro-prudential oversight in the EU, the ECB explicitly indicated in 2001 that its Banking Supervision Committee would perform that role (see Economic and Financial Committee, *Report on financial crisis management* [Brouwer 2 report], July 2001, p. 7). It is expected that as a result of the crisis financial stability will become a more pronounced objective of the ECB (see Paul De Grauwe and Daniel Gros, *A New Two-Pillar Strategy for the ECB*, CEPS Policy Brief No. 191 [Brussels: CEPS, June 2009]).

8 On the US, see Emil Henry, "Daunting Decisions on a New Risk Regulator", *Financial Times*, June 11, 2009. See also US Treasury, *Financial Regulatory Reform: A New Foundation, Rebuilding Financial Regulation and Supervision,* June 2009 and Alex Pollock, *Advice, Not Consent: A Case for a Systemic Risk Adviser and against a Systemic Risk Regulator,* June 2009 on the US and Lorenzo Bini-Smaghi, "After the Big Bang: Regulation and Supervision after the Financial Turmoil", Speech at the 4th International Conference of Financial Regulation and Supervision "After the Big Bang: Shaping Central Banking, Regulation and Supervision", Bocconi University, Milan, June 2009 on the EU.

have arisen from the fact that the Committees forming the basis of the three future authorities have their seats in the (business) capitals of the three most important member states of the EU, respectively Paris, London and Frankfurt.

The ESFS will be responsible for:

- moving towards the realisation of a single rulebook and its enforcement;
- ensuring harmonised supervisory practices and peer review of national authorities,
- strengthening the oversight of cross-border groups and supervise pan-European entities,
- establishing a central European database aggregating all micro-prudential information and
- ensuring a coordinated response in crisis situations.

The three authorities will be established as regulatory agencies under EU law, following Article 95 of the EU Treaty. Although the Council stated that the choice of the legal basis has not yet been taken, the Commission proposed in its Communication Article 95 of the EU Treaty, relating to the adoption of measures for the approximation of legislation for the functioning of the internal market. Since the agencies will work on the development of a single rule book to ensure uniform application of rules in the EU, they will contribute to the functioning of the internal market.

The use of Article 95 has another advantage, in that the decision to establish the authorities could be taken by qualified majority vote (QMV) in the EU Council. This compares to Article 308, which requires unanimity. As some member states may not be so keen to delegate large powers to the agencies, QMV would allow the European Commission to go for a broader mandate.[9] On the other hand, Article 95 requires co-decision with the European Parliament, which is not the case for Article 308, implying that the decision process under Article 95 will take longer. In any case, for such important decisions, it is advisable to have them taken by as unanimous approval as possible.

Much now depends on the precise elaboration of the mandate of the agencies in the Commission's proposals, adopted on 23 September, and the discussions in the European Parliament and the EU Council of Ministers. Among the 28 EU regulatory agencies existing at present, no general rules apply governing their creation and operation. They were set up on an

9 The basis could be challenged by the member states. In 2004, the UK challenged the choice of Article 95 EC as the legal basis of the European Network and Information Security Agency (ENISA) before the European Court of Justice and stated that Article 308 EC was the only possible legal basis. The Court ruled that the use of Article 95 EC was appropriate for ENISA, as it constituted a part of the normative context directed at completing the internal market in the area of electronic communications. See Sami Andoura and Peter Timmermann, *Governance of the EU: The Reform Debate on European Agencies Reignited,* EPIN Working Paper No. 19 (Brussels: European Policy Institutes Network, October 2008), p. 7.

ad hoc basis rather than via a coherent administrative and/or regulatory method. Consequently, large differences exist between them when it comes to their functions, organisational structure and funding provisions.[10] Given the supervisory problems raised by the crisis, a precise proposal on the mandate, tasks, organisation, decision-making procedures, funding and accountability of the new agencies is crucial.

In comparison to the tasks assigned to the 'Level 3' Committees (3L3), as created by the 2001 Lamfalussy report, the workload has been magnified significantly. Whereas the 3L3 had an essentially advisory task on regulatory matters – advising the European Commission on implementing rules – the new authorities will in addition have many supervisory duties. The realisation of a single rulebook and the consistent application of EU rules continue and extend regulatory tasks of the Committees. In this regard, the Council conclusions mention that a mechanism should be developed to ensure more consistent application of EU law and a tougher sanctioning regime for cases of non-respect. But the addition of supervisory responsibilities and the constitution of a central supervisory database will impose a new and heavy workload. The Council conclusions mention, inter alia:

- coordinating the supervisory analyses of financial groups,
- ensuring consistency in supervisory outcomes across financial groups,
- participating and eventually mediating in supervisory colleges,
- supervision of pan-European entities and
- developing common training for supervisors.

To imagine what this means in terms of increased workload, one can recall that on the banking side alone, there are 123 different supervisory colleges.[11] If the new European Banking Authority (EBA) needs to participate in all these meetings, and coordinate the supervisory analyses, this will require a multiplication of the staff of the current Committee of European Banking Supervisors (CEBS). For comparison, the average number of staff members of the European regulatory agencies is 157 persons.[12]

The extensive supervisory tasks may cause problems with the member states and raise the question of the powers of the agency. According to Court jurisprudence, the authorities can not exercise more powers than the delegating authority possesses under the EU Treaty.[13] Some of the responsibilities listed above could be on the borderline between tasks falling to the EU under the Treaty, and those remaining a member state competence. In addition, the question regarding who is in charge of enforcement can be raised. Under the 2001 Lamfalussy report, the hardly mentioned 'Level 4', i.e. enforcement, was a Commission competence,

10 Ibid., p. 9.

11 Karel Lannoo, *Concrete Steps towards More Integrated Financial Oversight*, CEPS Task Force Report (Brussels: CEPS, December 2008), p. 32.

12 Andoura and Timmermann, *Governance of the EU,* 2008, p. 11.

13 See the landmark Meroni case (9/56, 1957–1958), as quoted in Andoura and Timmerman, *Governance of the EU,* 2008, p. 12, in which the European Court of Justice clarified the conditions under which a delegation of powers could be granted to a new entity.

whereas under the new proposals on the table, the ESAs would share enforcement competences with the EU Commission.

The coming into force of the Lisbon Treaty should facilitate the implementation of this new framework, particularly with the single rulebook and the harmonised supervisory practices. The Lisbon Treaty clarifies the hierarchy of norms in the EU's regulatory framework and distinguishes between legislative acts, delegated acts and implementing acts.[14] It would replace the current 'comitology' framework, which, for financial markets, was the centrepiece of the Lamfalussy report 2001). A delegated act assigns to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of a legislative act. An implementing act will be adopted "where uniform conditions for implementing legally binding Union acts are needed", which confers implementing powers on the Commission. This should allow the current level 3 of Lamfalussy to become binding.

The degree of independence to be accorded the European Supervisory Authorities (ESA's) remains ambiguous. The Council conclusions reiterate that the ESAs should be independent vis-à-vis both the national authorities and the European institutions. But they will assist the Commission in the consistent interpretation and application of Community law. And the decisions they take should not impinge on fiscal responsibilities of the member states, which severely restricts their powers. A problem in this regard is the supervision of pan-European entities. Recent EU decisions have already anticipated the creation of the ESAs. For example, the new regulation on credit rating agencies (CRAs) gives the Committee of European Securities Regulators (CESR) certain competences in the supervision of these bodies. CESR should facilitate the registration of CRAs in the EU and can mediate in the supervisory college.[15] Other possible areas for pan-European supervision are central counterparties and securities settlement systems. The Ecofin Council conclusions note that some member states do not agree with this approach, since it could affect national fiscal responsibilities (Council conclusions, p. 5). The same reasoning applies for crisis management, where it seems that the ESAs will exercise limited responsibility for emergency *regulatory* decisions, such as short-selling restrictions. However, they will rapidly be asked to participate and mediate in *supervisory* decisions, as the European or neutral partner in colleges of supervisors. Mediating in supervisory colleges will rapidly raise fiscal issues, *nolens volens*, hence the fiscal carve-out in the Council conclusions, subsequently proposed in the Commission drafts, is a fig leaf.

The Council conclusions are less detailed on the governance of the ESAs than on the ESRB. They only call for a Steering Committee of the ESAs to reinforce mutual understanding and coordinate information-sharing. More detail is provided in the Commission drafts, which propose a heavy

14 Treaty on the Functioning of the European Union, Articles 249–249d.

15 Regulation (EC) of 14 July 2009 of the European Parliament and of the Council on credit rating agencies, awaiting publication in the Official Journal.

structure composed of a supervisory board, a management board, a permanent chairman and director, and an appeals mechanism.

The weakness of the European solution for micro-prudential supervision is that, out of *realpolitik* considerations, the EU chose to maintain the functional model of supervision at EU level. Supervision by objective would have been better adapted, leading, following the principle of subsidiarity, to a more rational and efficient allocation of responsibilities at European level. The current structure will give rise to duplication of tasks and confusion in the allocation of responsibilities. A more integrated structure, for example, to supervise pan-European entities or constitute a European supervisory database would be much more effective. On the other hand, compared to the proposed supervisory reform in the US, where the only structural change in the White House proposals on the micro-prudential side is the merger of the Office of Thrift Supervision (OTS) and the Office of the Controller of the Currency (OCC) the European structure may over time become more integrated, provided the mandate of the new authorities is sufficiently comprehensive, and the EU member states contribute constructively to the new structure.[16]

The post-crisis regulatory agenda

The new European Parliament will have to face the dual challenge of dealing with the legislation on the adaptation of the institutional structure on top of the post-crisis regulatory agenda. The latter is driven by international (G20) as well as European single market considerations. Some parts of this agenda have already been completed, but others have just been initiated or are still in the pipeline.

The crisis revealed important shortcomings in the regulatory framework, to the extent that a core principle of the single market, the single passport and home country control, was called into question. To restore this principle, the European Commission will have to engage in moving towards a much higher degree of harmonisation in certain areas. Following the EU's 1993 deposit protection directive, three different schemes of protection co-exist: the protection offered to the home country (applicable to the head offices and its branches or through free provision of services), the protection offered to the host country (in case the bank is a subsidiary of a foreign bank) and the home country scheme 'topped up' with the level offered by the host country (in case the level of protection for a branch operating in the host country is lower than that of its home country). Until the crisis broke out, an overwhelming majority of consumers was not aware of the consequential differences in protection schemes. In the midst of the crisis, the member states provisionally agreed in the EU Council to increase the minimum level to €50,000, but did not change the basic ele

16 Recent proposals of the US Senate propose the creation of a single regulator in the US, away from the Federal Reserve, See Chris Dodd proposals.

Table 1
Status of post-crisis financial services legislation

Measure	*Purpose*	*Status*
Depositor protection schemes	Increase minimum level of protection to €50,000	Adopted October 2008, report by end-2009
Credit rating agencies	Introduce single licence	Adopted April 2009
Amendments to capital requirements Directive (CRD)		
▸ securitisation	▸ min. 5 percent on a bank's books	Directive (adopted April 2009)
▸ executive remuneration	▸ extra charge for high pay packages	Draft directive (July 2009)
▸ trading book and complex financial products	▸ higher capital for trading book	Draft directive (July 2009)
Hedge funds	Regulate non-regulated segment of fund industry	Draft directive (April 2009)
Prospectus Directive	Possible review	Consultation (January 2009)
Investor compensation schemes	Possible review	Consultation (February 2009)
UCITS IV	Implementing measures	Consultation of CESR (March 2009)
Market abuse	Improve and simplify directive	Consultation (April 2009)
Depositaries of funds	Segregate funds from depositaries	Consultation (May 2009)
OTC markets	Transparency, mandate some central clearing	Consultation (June 2009)
European Systemic Risk Board	Indentify macro-financial risks	Consultation (June 2009), draft regulation and Council decision (September 2009)
European Banking Authority	Coordinate banking regulation and supervision	Consultation (June 2009), draft regulation (September 2009)
European Insurance Authority	Coordinate insurance regulation and supervision	Consultation (June 2009), draft Regulation (September 2009)
European Securities Markets Authority	Coordinate sec. markets regulation and supervision	Consultation (June 2009), draft Regulation (September 2009)
Omnibus directive	Adapt existing rules to ESFS	Draft directive (October 2009)
Crisis resolution procedures	Coordinate national rules	Consultation (October 2009)

ments of the 1993 EU directive, nor the method of funding or the statute. The European Commission will need to report before the end of 2009 on how to reform the system for the long term.

Other elements will need to be reformed to get consumers back on board regarding the single market. Mortgage lending, for example, is not subject to any degree of EU harmonisation, whereas (short-term) consumer lending is. Although mortgage lending is about 9 times more important than other forms of consumer credit, a consultation in 2007 concluded that the different forms of national legislation seemed to work well enough, and that there was no immediate need for European harmonisation.[17] However, principles such as responsible lending and loan-to-value ratios could well be harmonised and enforced at European level, as lax mortgage lending standards in one member state has European-wide implications.

A forceful Commissioner in charge

A prerequisite to a credible European agenda is a forceful and credible Commissioner in charge. The outgoing Commissioner for the single market had by the end of his term lost all credibility. Charlie McCreevy's initial slogan was "regulatory pause" after his predecessor Frits Bolkestein had pushed through the heavy Financial Services Action Plan. The Commissioner gave priority to market-driven solutions, including self-regulation, before going for new regulation. Even in the first months of the crisis, McCreevy hesitated to call for new regulation, for, for example, credit rating agencies or deposit guarantee schemes. He also did not dare initially to oppose the dominant attitude in the EU Council of Finance Ministers that the crisis did not signal the need to introduce changes to the institutional structure of supervision. It was only by May 2008 that the Commissioner started to change his position and called for a regulatory response. Moreover, the initiative to establish the de Larosière Group in October 2008 was taken by the Commission President, not by Commissioner McCreevy.

In a related vein, consideration should be given to a possible re-distribution of the internal market portfolio. As one of the cornerstones of the EU, the internal market could command the full attention of two or three commissioners. Financial services matters alone deserves a single commissioner, especially for the next five years, when the Commissioner will have to push a heavy agenda through the EU Council and European Parliament, and take on additional responsibilities in the ESRB and ESAs. A forceful Commissioner will thus be extremely important for the Commission to regain the initiative in this policy domain.

17 European Commission, *White Paper on the Integration of EU Mortgage Credit Markets,* COM(2007)807 final, December 2007.

Conclusion

The EU institutions face a difficult and precise balancing act in the proposals for a new framework for EU supervision. The legislation need to lay down as clearly as possible the objectives, functions, organisation, governance and funding of the new entities proposed by the de Larosière report, while at the same time garnering the support of a 'qualified' majority of member states. Since the Commission follows the Article 95 route, its proposals go as far as possible within the limits of the EU Treaty. But the legislation will for the first time mark a structural change in the framework for financial supervision in the EU, creating three new entities with separate legal personality, and a huge workload.

The measures to be decided upon in the follow-up to the de Larosière report come on top of the consultations and proposals for new measures that the European Commission is involved in as a result of G20 commitments and the further completion of the single market. All these will have to be pushed through in a context of a new European Parliament and a new European Commission, which does not augur for a swift decision process.

But will this be enough to restore the single market? The financial crisis and the large state aid packages have forced ailing banks to re-focus on their home market and reduce their activities abroad. Market integration is declining and competition diminishing. It will take time before the effects of the measures discussed above become visible and the single market process advances again.

Tackling Europe's Legitimacy Crisis – A Republican Approach to Euroland's Governance

Stefan Collignon

Abstract

This article discusses the challenges for democratic legitimacy and efficient governance in the EU in general and in the European Monetary Union in particular. The author perceives a deteriorating legitimacy of the integration project and argues that this sentiment of disenchantment towards the EU could spill over to European Monetary Union. The crisis of legitimacy originates from the diminishing capacity of today's intergovernmental governance to produce results efficiently, because the current set-up does not compensate this loss with additional democratic input legitimacy. A democratic European government could solve these problems in particular for the European Monetary Union which constitutes the most densely integrated core of the EU.

Half a century after the signing of the Treaty of Rome, European integration is in a crisis. We observe a slow and gradual deterioration in the approval ratings of the integration process by European citizens. The percentage of those who think that "the European Union is a good thing" has fallen from 75 percent to below 50 percent over the last 20 years.[1] More and more frequently, referenda on European constitutional issues have failed, including in two founding Member States, France and the Netherlands, in 2005. It may not be a coincidence that this development started around the time of the Maastricht Treaty,[2] although it probably has its roots in the important changes brought about by the creation of the Single Market. Unless European policy makers start facing up to this crisis of legitimacy and deal with the necessary measures for improving the European Union's acceptance, the whole project risks falling apart. After the Euro, the single market would go. The Euro is an economic success, but politics remains its Achilles Heel.

This paper argues that the roots of Euroscepticism are found in the deteriorating legitimacy of the integration project, and this disenchantment with the EU could spill over to the European Monetary Union. The crisis of legitimacy originates from the diminishing capacity of today's intergovernmental governance to produce results efficiently, because the current set-up does not compensate this loss by additional democratic input legitimacy. A democratic European government could solve these

1 See various editions of *Eurobarometer*.

2 The Danish referendum on Maastricht was the first No-vote, the French referendum approved with a narrow majority.

problems and this is particularly important for the European Monetary Union which constitutes the most densely integrated core of the EU.

Roots of Euroscepticism

For a long time the legitimacy of European integration was derived from the positive results that the integration process generated for ordinary citizens. Europe was built on a triple promise: peace, prosperity, and democracy. Today, the promise seems increasingly compromised. It is true that peace within the European Union remains assured, if "peace" is defined as the absence of military action. But defending narrow national interests[3] and promoting protectionist beggar-your-neighbourhood policies are new forms of aggressive behaviour that undermine the common concerns and interests of all European citizens. Nor is the European Union any longer seen as an unambiguous instrument for improving the prosperity of its citizens. It is criticised for promoting neoliberal policies that undermine the European social model, increase insecurity and keep wages down. Europe is seen as part of the problem of globalisation, rather than its solution. Finally, there is growing criticism of a democratic deficit in the EU. People are aware that policies are decided through bureaucratic procedures where governments negotiate regulations, while they themselves are never able to exert real choices over the outcome. All these perceptions feed the broad and growing sentiment of euroscepticism. They are likely to be enhanced by the current financial and economic crisis, especially when the real economic effects will be felt in terms of rising unemployment. And when people have a numb feeling that Europe is not helping them, they may wish to return to the familiar "good old world", where the nation state protected them and governments could manipulate exchange rates.

The reality is, of course, more subtle and complex, although this picture is not entirely wrong. The integration of European markets has contributed to faster economic growth and the macroeconomic stability that came with the Euro has created 18 million jobs in seven years. But these gains were unevenly distributed. Productivity grew most rapidly in sectors producing tradable goods and this has contributed to greater prosperity. But in the more traditional and closed sectors of non-tradable goods, wages and profit margins have come under systematic pressure from international competition.[4] Wage bargaining behaviour has also not fully adapted to the single currency regime, increasing the risk of rotating slumps.[5] European market integration is, therefore, not a simple Pareto optimising contract, to which individuals voluntarily adhere because it generates only

3 I define "narrow" national interest as not taking into account the overall welfare of people who are simultaneously citizens of the Union and the nation state.

4 Stefan Collignon and Daniela Schwarzer, *Private Sector Involvement in the Euro. The Power of Ideas* (London: Routledge, 2003).

5 Stefan Collignon, *Wage Developments in Euroland or: the Failure of the Macroeconomic Dialogue*, 2009, www.stefancollignon.de/PDF/WagedevelopmentsinEuroland34.pdf.

gains and no losses. Integration produces comparative advantages to some and external costs to other sectors. Welfare theory recommends in such cases to arrange compensation from those that are made better off to those that are made worse off so that all would end up no worse off than before.[6] Redistribution can be a matter of efficiency, not only of equity. But this insight has escaped European policy makers.[7] Political elites in the EU have mostly emphasised the gains from market integration, while they have only marginally compensated and mainly ignored the losers. Critics (e.g. in organisations such as attac or the radicalised right and leftwing parties that have gained ground in many member states) accuse the neo-liberal policy consensus in Europe that puts free markets and competition above all other considerations as being responsible for the deteriorating standards of living in some sections of European society.

No doubt, the ideological hostility against redistribution in the neo-liberal age has contributed to this stand-off, but Europe's institutional arrangements have also been a major obstacle to the construction of a fairer European Union.

In the case of the European Monetary Union, setting up an independent European Central Bank increased the efficiency of monetary policy and welfare, but this was largely a technical arrangement and not an issue for democracy. In a modern democracy, income redistribution is a matter of public choice and subject to the democratic vote when people are electing their governments. But the EU is not a democracy; European citizens cannot elect a European government. Most policies are negotiated among member state bureaucracies, with the Commission acting as their handmaiden. The intergovernmental method of policy-making does not only prevent the emergence of a genuine democracy, but it is also hollowing out the democratic content of nation states and the citizens' capacity for making collective choices. The reason is that for a significant range of public policies, national governments must find consensus among themselves. This is very different from the ECB, where a centralized institution takes decisions. The negotiated arrangements amongst governments will then need to be ratified by national parliaments. But other than in exceptional circumstances, this ratification does not allow national parliaments to refuse or modify the intergovernmental agreement, as this would put the whole compromise into question. National parliaments must support their national governments, for otherwise governments could not speak and act on behalf of their nation. Of course, governments can define "red lines" in

6 Tibor Scitovsky, "A Note on Welfare Propositions in Economics", *Review of Economic Studies*, Vol. 9, No. 1 (1941): 77–88.

7 The most notable exception was Commission President Jacques Delors, who introduced the so-called Delors I and II Packages as regional transfer payments in response to a report written by Tommaso Padoa-Schioppa et al., *Efficiency Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community* (Oxford: Oxford University Press, 1987). This report emphasized the need of complementing the creation of the single markets with monetary union and redistributive policies.

advance, beyond which they would not accept a deal.[8] This is part of the usual negotiating tactics. But the outcomes reflect the utility maximising calculations of governments, who seek to balance the demands from their constituencies at home with the negotiating positions of their partners in Europe, given the constraint of the EU's institutional rules and structures. Putnam has described this interaction as a two-level game.[9]

It is often ignored that under this form of governance, the input of popular preferences from the local level into the decision making process at the European level is *necessarily* weak because of principal-agent problems and inevitable policy externalities.

Principal-agent problems occur when an agent (here a national government) is charged to represent the interests of the principal (here the national constituency), but due to asymmetric information and diverging preferences (e.g. wanting to find an agreement with other member states) the agent will perform actions that stand in contradiction with the principal's preferences.

Policy externalities occur when a government's decision causes costs (or benefits) to third party stakeholders, frequently from the use of public goods. Governments strike a bargain with their partners from which *they* have no incentive to deviate as long as their partners do not deviate from the agreement.[10] However, this solution is not necessarily identical with the solutions preferred by the different national constituencies.[11]

The gap between what people want and what they get from the policy compromise is a cost to citizens. In the most favorable case the outcome of the intergovernmental negotiation minimizes opposition from national constituencies. But even this optimal solution will usually impose external costs on citizens in terms of their frustrated preferences. As long as they appear to be closer to national preferences than to the bargained equilibrium, governments can "blame" these costs on the European Union, so that they will not bear the full costs of their decision and this in turn weakens the democratic control mechanism.[12]

8 The Lisbon Treaty has even extended the power of setting red lines to national parliaments, which could make it even more difficult to govern Europe efficiently.

9 Robert D. Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games", *International Organization*, Vol. 42 (Summer 1988): 427–460.

10 Game theory calls this Nash equilibrium.

11 Bunsson noted that political organizations are inevitably confronted with multiple constituencies (Nils Brunsson, *The Organization of Hypocrisy: Talk, Decisions and Actions in Organizations* [Chichester: John Wiley and Sons, 1989]. See also Stephen Krasner, *Sovereignty. Organized Hypocrisy* (Princeton, N.J.: Princeton University Press, 1999). To keep this text short and simple we assume that the majority in a national constituency reflects the preferences of the whole nation. In reality this is rarely the case so that intergovernmental policy decisions are a form of unintentional gerrymandering. (Gerrymandering is the dividing of a state, county, etc., into election districts so as to give one political party a majority in many districts while concentrating the voting strength of the other party into as few districts as possible.)

12 From a theoretical point this is a consequence of the fact that within national constituencies, preferences for European and national policies are not separable and have

In the classic model of democracies in nation states, by contrast, preference frustration resulting from majority decisions is mitigated by the underlying sense of solidarity, which may be based on feelings of identity or constitutional patriotism. In the EU, cross-border solidarity is weak because political activism, which generates links of respect and solidarity, is focused on national power centers and not on a European government. Hence, this form of governance is not efficient and welfare enhancing. It precludes redistributive policies, which by redistributing single market gains to potential losers could foster public consent to European integration.

The problem of policy frustration that is gradually delegitimising the integration process cannot be overcome by renationalising policies or by strengthening the role of national parliaments. Better surveillance by national parliaments is often suggested[13] in order to improve the balance of power of the principal over the agent. But in the European context, this is no solution. For, if the intergovernmental compromise is drawn closer to the national principal with the strongest control-powers, but preferences between different national constituencies diverge, then preference frustration will necessarily increase in other member states. This problem results from externalities and not from "bad" policies.

Economic theory has proposed two solutions for dealing with the problems of externalities. One is to assign property rights that allow participants to negotiate compensation at individual levels.[14] The other is setting up a government that intervenes with rules and regulations in order to minimise welfare losses. The first solution does not work in the European Union, because it is often impossible to assign property rights for public goods. For example, excessive deficits are likely to increase interest rates; although the whole Euro area is affected by high government borrowing, it is impossible to assign a right to low interest rates. The second approach worked with respect to monetary policy in Europe by setting up the ECB, but in other policy fields it is handicapped by the lack of a European government. Centralising policy making power would require democracy at the European level and this remains impossible as long as member states remain autonomous in their decisions.

In this context, European redistributive policies can only take place at the level of inter-state transfers between member states because sectoral compensation for losers in the single market would transcend the territorial definition of state sovereignty. For example, taxing gains from integrated markets and transferring the income to potential losers would

different salience. See Melvin Hinich and Michael Munger, *Analytical Politics* (Cambridge University Press, 1997).

13 See for example the Decision by the German Constitutional Court on the Lisbon Treaty, Bundesverfassungsgericht, *Entscheidung zum Lissaboner Vertag*, BVerfG, 2 BvE 2/08, June 30, 2009, Paragraph No. (1–421), www.bverfg.de/entscheidungen/es20090630_2bve000208.html.

14 Ronald H. Coase, "The Problem of Social Cost", *Journal of Law and Economics*, Vol. 3 (October 1960): 1–44.

require unanimity among member states, which is hard if not impossible to obtain.

The second best solution has been redistribution through the EU budget. This method was initiated by the Delors I and II Packages, which have evolved into Structural Funds and the fully-fledged regional policy. Each member state pays a contribution into the EU-budget, more or less according to GDP shares, and receives payments for specific projects. But this approach suffers from the logic of collective action,[15] according to which the provision of public goods is hampered when individual actors have incentives to free-ride and do not want to pay for others. This can be observed in the European budget debate, which is dominated by concerns about net contributions from national budgets ("I want my money back", as Thatcher famously claimed), and not about who deserves support or who can be made to pay most from the gains obtained by European integration. Thus, we may conclude that the latent crisis and the growing disenchantment with the process of European integration have profound roots in the governance of the European Union itself.

Output legitimacy's diminishing returns

Nevertheless, the European Union would not be what it is without the intergovernmental method of governing Europe. Cooperation through mutual recognition between governments was a crucial factor in setting up the single market. Previous attempts of regulatory harmonisation by the so-called community method had failed. In other areas, such as competition or common agricultural policy, not to mention monetary policy, delegation to a supranational authority contributed to successful integration. Through these two parallel methods, the European Union has evolved into a system of governance with a thick range of public policies that affect all European citizens in their entireness. Borrowing from the literature of public finance, these policies can be called *European public goods* – Europe's *res publica*.[16] For example, the single market or the common agricultural policy affect the quality and security of all European consumers and require common health and safety standards. Competition policy is necessary to ensure that price distortions will not harm consumer interests or damage efficient producers by unfair subsidies. With the introduction of the Euro, the range of European public goods has further increased: the inflation rate, the interest rate, the exchange rate, but also fiscal policy and even wage settlements have all become European policy goods that directly or indirectly affect each citizen in the Euro area. European public

15 Mancur Olson, *The Logic of Collective Action. Public Goods and the Theory of Groups* (Cambridge, Mass.: Harvard University Press, 1971).
16 Stefan Collignon, *Viva la Repubblica Europea!* (Venezia: Editore Marsilio, 2008); Stefan Collignon, *Bundesrepublik Europa? Die demokratische Herausforderung und Europas Krise* (Berlin: Vorwärts Verlag, 2007); Stefan Collignon, "Is Europe Going Far Enough? Reflections on the EU's Economic Governance", *Journal of European Public Policy*, Vol. 11, No. 5 (2004): 909–925.

goods have also emerged in other policy domains, such as controlling the common borders in the Schengen Area, fighting trans-border crime or the international representation of common interests.

How important in quantitative terms are these European public goods? Referring to a remark by former Commission President Jacques Delors, it is often claimed that 80 percent of all legislation in the EU originates today at the level of European institutions. Measuring the "Europeanisation" of policy making poses significant methodological difficulties. Some studies for Germany claim a range closer to 10 and 35 percent,[17] but Hoppe has confirmed that the stock of Europeanised legislation is close to 80 percent of the national.[18] Be this as it may, these estimates indicate that a highly relevant and thick range of European public goods are now regulated at the European level.

What were the mechanisms that propagated this development? In the early phase, some clearly delineated projects were able to yield synergies and economies of scales when governments cooperated and this contributed to the improvement of general welfare. The congruence and complementarity of interests between governments and citizens were derived from these positive externalities and became the foundation of the "permissive consensus", which allowed the progressive construction of European public goods.[19] Their existence nourished optimism about the inevitability of European unification. Even today, after the permissive consensus has vanished, some policy makers still believe that synergies from integration are sufficient to legitimise the Union.[20]

But potential welfare gains alone are not sufficient to explain the dynamics of integration. A more realistic model was provided by neo-functionalist integration theorists.[21] They argued that each step of *partial* inte-

17 Andrew Moravcsik, "The European Constitutional Settlement", *The World Economy*, Vol. 31 (2008): 157–182; Andrew Moravcsik and Annette Töller, "Brüssel regiert nicht Deutschland", *Financial Times Deutschland*, February 10, 2007.

18 Tilman Hoppe, "Die Europäisierung der Gesetzgebung: Der 80-Prozent-Mythos lebt", *Europäische Zeitschrift für Wirtschaftsrecht*, No. 6 (2009), p. 169. This study, made by the academic service of the Bundestag, has also been quoted by the German Constitutional rule on the Lisbon Treaty.

19 Leon Nord Lindberg and Stuart Allen Scheingold, *Europe's Would-be Polity: Patterns of Change in the European Community* (Englewood Cliffs, N.J.: Prentice-Hall, 1970); Pippa Norris, "Representation and the Democratic Deficit", *European Journal of Political Research*, Vol. 32 (1997): 273–282; Achim Hurrelmann, "European Democracy, the 'Permissive Consensus' and the Collapse of the EU Constitution", *European Law Journal*, Vol. 13, No. 3 (May 2007): 343–359.

20 See for example, Wim Kok, "Facing the Challenge. The Lisbon Strategy for Growth and Employment", European Communities: http://europa.eu.int/comm/lisbon_strategy/index_en.html. The former Dutch Prime Minister, who was asked to assess the (non-) progress of the Lisbon Strategy: "Actions by any one Member State [...] would be all the more effective if all other Member States acted in concert; a jointly created economic tide would be even more powerful in its capacity to lift every European boat. The more the EU could develop its knowledge and market opening initiatives in tandem, the stronger and more competitive each Member State's economy would be."

21 See Ernst B. Haas, *The Uniting of Europe. Political, Social and Economic Forces, 1950–1957* gration destabilises the *general system* of governance in Member States and therefore requires further steps of integration. This logic can explain, positively, the gradual construction of an "ever closer Union", but it implies also, negatively, diminishing democratic power in the nation state. This second aspect is often overlooked. Realist scholars have objected that nation states have remained the principal actors of the integration process,[22] because states conclude the international treaties on which the European edifice is built. They also argue that governments will pursue such policies as long, and only as long, as it serves their interests and they assume that governments have identical preferences across time and space, namely to stay in power and promote the security, prosperity and values of their constituents.[23] However, as Moravcsik has rightly pointed out, preferences change within the constituencies.[24] This poses the problem of legitimacy, because governments need to respond to the changing demands from their constituencies. Realism does not dispense us from dealing with the issue of legitimacy in European integration.

50 years of European integration, 25 years of the single market, 20 years since Maastricht and ten years of the Euro have transformed the quantity of European public goods and the quality of policy making in the European Union. As a consequence, it becomes more and more difficult to implement policies which generate legitimacy because people are happy with the results.[25] The diminishing returns for output legitimacy are partly caused by the deepening of European integration, but also by the enlargement of the Union.

First let us look at the consequences of deepening integration. The single market and in particular the adoption of the Euro have added a whole range of new polices, which no longer follow the traditional logic of synergies and positive externalities. They are hampered by the logic of collective action.[26] With respect to these policies and the public goods they generate, the interactions between policy makers are dominated by strategic substitutabilities and negative externalities.[27] Governments no longer have an incentive to cooperate, because they could improve their position by free-riding on the behaviour of others. This is detrimental to the welfare of European citizens. Borrowing from the theory of common resource goods, we may call the European public goods that provide incentives for policy makers to behave non-cooperatively "exclusive" Euro-

(Notre Dame, Indiana: University of Notre Dame Press, 2004).

22 Alan Milward, *The European Rescue of the Nation-State* (London: Routledge, 1992).

23 Krasner, *Sovereignty. Organized Hypocrisy*, 1999, p. 7.

24 Andrew Moravcsik, *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* (Ithaca: Cornell University Press, 1998).

25 This was recognized by Joschka Fischer's Humboldt University speech in 2000. See Joschka Fischer, "From Confederacy to Federation: Thoughts on the Finality of European Integration" (2000); download www.jeanmonnetprogram.org/papers/00/joschka_fischer_en.rtf.

26 Olson, *The Logic of Collective Action*, 1971.

27 Russell Cooper and Andrew John, "Coordinating Coordination Failures in Keynesian Models", *Quarterly Journal of Economics*, Vol. 103 (August 1988): 441–463.

pean public goods and those that generate positive incentives "inclusive" public goods. The class of exclusive European public goods cannot be administrated by voluntary intergovernmental cooperation, but it needs the unified authority at the level of a European government.[28] Monetary policy is the model case. Preventing monetary distortions in the single market required exchange rate stability, and this was not compatible with autonomous national policies.[29] By transferring full responsibility for monetary policy to the independent ECB, the destabilising conflict between national authorities was eliminated.

For exclusive European public goods, which follow this logic, synergies are less easily available, but the temptation to free-ride and do the opposite of what serves general welfare has increased. This is why the creation of the Euro has profoundly changed the policy game. Macroeconomic stability is littered with exclusive public goods. Fiscal policy is a good example. If each and every Member State in the Euro area would balance the budget, as required by the Stability and Growth Pact, the overall effect would be low levels of interest rates.[30] However, at low interest rates the cost of public borrowing is low – certainly lower than the political cost of cutting expenditure or increasing taxes for individual governments. Hence, each government has an incentive to increase its own borrowing while insisting that everyone else should adhere to the Stability and Growth Pact. The system generates hypocrisy and the overall outcome is a less than satisfactory level of public borrowing and higher than optimal interest rates. The theory of fiscal federalism has therefore argued that the stabilisation function of government expenditure needs to be centralised.[31]

The difficulties, which are caused by collective action problems, also show up in the EU's weak and uncoordinated response to the financial and economic crisis. While the United States were the hardest hit and responded with a massive programme of economic stimulus through tax cuts, public expenditure and banks' restructuration, European governments found it difficult to agree on a coherent strategy. Germany first resisted any stimulus, France was propagating it. A recovery programme was coordinated by the European Commission that largely re-bundled previously planned fiscal measures. The conflict between the French and German governments was papered over by window-dressing; little concerted action followed. As a consequence, the American recession has been sharp, but short. In Europe it has been slow, deep and persistent.

28 Stefan Collignon, *The European Republic. Reflections on the Political Economy of a Future Constitution* (London: The Federal Trust/Kogan Press, 2003); Collignon, *Is Europe Going Far Enough?*, 2004.

29 Tommaso Padoa-Schioppa et al., *Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community* (Oxford: Oxford University Press, 1987).

30 We focus here on the equilibrium interest rate and not on market or policy induced fluctuations due to shocks and the business cycle.

31 Richard Abel Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (New York and London: McGraw-Hill, 1973); Wallace E. Oates, *Fiscal Federalism* (New York/Chicago: Harcourt Brace Jovanovich Inc., 1972).

Incentive problems also hit Europe's capacity for reform when individual Member States seek to preserve temporary comparative advantages at the expense of their neighbours. The French government, for instance, has sought to protect its domestic electricity market, while the government-owned electricity company EDF has benefitted from open markets in other member states. This has deprived French consumers of lower prices and competitors of reaping economies of scale in the French market. Another example is Germany, which has been cutting its unit labour costs to levels below those of others Euro area members, thereby building up substantial comparative advantages.[32] At the same time the German government has refused to increase deficit spending, arguing that this would burden future generations. But when other governments stimulate the economy, the benefits accrue disproportionally to Germany, because the competitive advantage accelerates German economic growth at the expense of other member states. This facilitates the reduction of public debt in Germany, but leaves others with higher debt-GDP ratios. Such systematic beggar-your neighbourhood policy makes it impossible for all European citizens to profit fairly from European integration and can, of course, never become a general policy maxim. It requires a European government to look after the interests of all European citizens.

Secondly, the consequences of enlargement. If member states have to agree to European policy decisions, intergovernmental forms of governance are losing their efficiency as the number of member states increases. The theory of collective action has also shown that the incentives for free-riding increase with the size of a group.[33] The larger a group of decision makers, the less likely it is to provide the right and efficient amount of the public goods that citizens desire. As the necessary contribution by every single Member State to make the policy output happen becomes smaller relative to the overall input required, individual Member States will be tempted to shirk, hoping that the other members will pay for them. However, given that this is a general incentive for each and every participant, the overall outcome will be an under-provision of the required public goods. For example, the deep recession after the financial crisis required a substantial and coordinated stimulus, but member states could free-ride on others by keeping their own borrowings down and hoping for the spill-over from their neighbours' stimulus. The temptation to free-ride is lower in small groups, because it is more obvious and easier to monitor if one single actor is behaving non-cooperatively. Thus, the capacity for efficient policy making in the EU of 27 member states is no longer the same as it was in the community of 6 or 12. As the Euro area increases in size, its macroeconomic performance will deteriorate.

The intergovernmental method of integrating Europe has successfully created the thick range of European public goods. This is its lasting achievement. But because this method also generates collective action

32 Collignon, *Wage Developments in Euroland*, 2009.
33 Olson, *The Logic of Collective Action,* 1971; Collignon, *The European Republic*, 2003, Annex II.

problems, it is no longer suitable to govern and administer these goods. If the logic has changed in the process of deepening and enlarging the Union, new forms of governing the European public good are needed. Developing these modes of governance will be particularly challenging for the EMU in the second decade of its existence.

Input legitimacy and the democratic requirement

Europe's common public goods need to be managed and administrated well. Good governance is an essential requirement for them to last and find the support and agreement by citizens. An integral part of good governance is that people can participate in the formulation of what is good, that their preferences, and the deliberation by which they are shaped, become input into the decision making process. At present the model of European governance is dominated by voluntary intergovernmental cooperation which excludes citizens. For the class of exclusive European public goods, this model is no longer sufficient to generate public consent. In the traditional nation state, a democratic government solves the problem, but no European government exists that can exercise power authoritatively by *directing and controlling* policies.

In fact, in the EU these two functions are split. The Lisbon Treaty assigns the right to *direct* policies to the European Council (the heads of State and governments)[34] and reduces the Commission to a function of *control*.[35] It defines the Council of ministers and the European Parliament as the two organs of legislation, but the power remains essentially in the hands of governments.[36] The Lisbon Treaty leaves, however, some room for this balance of power to shift,[37] and this could strengthen democracy and popular support in the long run. But the Commission could only be transformed into a European government in the proper sense, if it had the will to do so and would seek its legitimacy from the Parliament rather than the Council.[38] More precisely, the College of Commissioners should become

34 Lisbon Treaty, Art 15.1: "The European Council shall provide the Union with the necessary impetus for its development and shall define the general political directions and priorities thereof." (Consolidated version, http://register.consilium.europa.eu/pdf/de/08/st06/st06655.de08.pdf).

35 Lisbon Treaty, Art 17.1: "The Commission shall promote the general interest of the Union and take appropriate initiatives to that end. It shall ensure the application of the Treaties, and of measures adopted by the institutions pursuant to them. It shall oversee the application of Union law under the control of the Court of Justice of the European Union." (Consolidated version, http://register.consilium.europa.eu/pdf/de/08/st06/st06655.de08.pdf).

36 This is also clear when national governments exert pressure on "their" national members of the European Parliament to vote in a certain way on issues that seem important to them. The grounds for doing so are the "national interest", which MEPs must not betray.

37 See, for example, Art. 17.2: "Union legislative acts may only be adopted on the basis of a Commission proposal, except where the Treaties provide otherwise."

38 The Lisbon Treaty stipulates in Art 17.7: "Taking into account the elections to the European Parliament and after having held the appropriate consultations, the European Council, acting by a qualified majority, shall propose to the European Parliament a can-the political decision-making body that is fully accountable to the European Parliament, while the Commission Service should become the European administration that works for the European government.

As long as the Commission remains dependent on the European Council, citizens cannot choose the direction and priorities of European policies. Policy deliberation is confined to the governmental technostructure and when citizens elect the European Parliament, their collective policy preferences remain of "second order". But when they elect their national parliaments, they cannot choose European policies either, because in national elections European and national issues are bundled together in the different party platforms where the national dimensions always dominate. Citizens then have the choice between bundles of national policies, which is, of course, the correct assignment: national elections should offer a choice over the directions for national governments, which administer national public goods.[39] But in the bundle they get European policies "for free", so to speak, because voters cannot put a separate price tag on what is specifically European.[40] Who then is choosing the direction for European policies? It is done by governments who are fairly autonomous in the way they conduct European policies, because they are mainly accountable to their national constituencies. We find here an asymmetry in the principal-agent relation of intergovernmentalism that prevents democratic control. Hence, *national* elections (and parliaments) cannot adequately control *European* public goods; they are structurally unable to legitimise policies that affect all European citizens. Furthermore, national elections exclude by definition the citizens of all other member states, so that democratic deliberation and public debates remain largely confined to national epistemic communities;[41] attempts by the European Commission to involve civil society with European policy making remain instrumental at best, but often artificial[42]. Consequently, under the

didate for President of the Commission. This candidate shall be elected by the European Parliament by a majority of its component members. If he does not obtain the required majority, the European Council, acting by a qualified majority, shall within one month propose a new candidate who shall be elected by the European Parliament following the same procedure." This article presents an opportunity for *une épreuve de force* between council and European Parliament, if the Parliament is willing.

39 In its ruling on the Lisbon Treaty the German Constitutional Court has insisted that maintaining the rights of sovereign states requires that these states can determine economic, cultural and social living conditions ("dass in den Mitgliedstaaten [...] ausreichender Raum zur politischen Gestaltung der wirtschaftlichen, kulturellen und sozialen Lebensverhältnisse [...] bleibt"). This is obviously only applicable to national public goods, as I have pointed out in the discussion on externalities above.

40 The dilemma is, of course, more general and applies to most foreign policy issues. But in the EU it is particularly acute because of the thickness of the range of European public goods.

41 For the role of epistemic constituencies in the European polity, see Collignon, *The European Republic*, 2003, and Collignon and Schwarzer, *Private Sector Involvement in the Euro*, 2003.

42 The European Commission has tried in recent years to stimulate debates between European NGOs, but they rarely have gone beyond the inner circle of militants (or present form of governance it is impossible for some European general will to emerge. This system is not optimal. Because it also easily blocks rapid and efficient decisions, even if unanimity is not required, it generates neither input nor output legitimacy; it is dominated by the partial interests of national governments and not by the popular will of citizens. It violates basic principles of democracy.

There is an answer to overcoming these problems: splitting responsibility for administrating national and European public goods. National governments continue to govern national public goods that cover national living conditions according to the institutions, traditions and conventions of historically grown nation states. Examples are local public goods such as building hospitals, schools, universities, providing social security, etc.

At the European level, a European government accountable to all citizens through the directly elected European Parliament is given responsibility for the administration of European public goods, such as macroeconomic management, defining the aggregate fiscal policy stance, supervising financial institutions in the Euro area, etc.[43] This agent would be able to design policies that affect and concern the interests of all European citizens together, and are based on democratic mechanisms. The European citizens could exert collective choices by voting for competing European policy programmes in the elections to the European Parliament, which then establishes the European government. As in any other representative democracy, majorities are built by capturing the median voter, and a European government would have to implement policies that respect the political preferences of the European median voter.[44] As a consequence, the policy preferences of all European citizens are no longer distorted by the segregation in separate member state constituencies. Competition for public office would cause the emergence of genuine European parties that seek majorities and winning coalitions across borders. The ensuing campaigns and debates generate the European public sphere where policies find their legitimacy. This would guarantee that the citizens' preferences regarding these European goods emerge from European-wide deliberation and are properly taken into account by the agent. In other words, if citizens' preferences with respect to different kinds of public goods serve as input into two separate policy making processes – one at the European, the other at the national level – collective action problems and the issue of policy externalities could be solved. These are the normal

lobbyists). By contrast, the policy debate about the Service Directive proposed by the Commission ("Bolkenstein Directive") resuscitated a broad public mobilization, because European citizens demanded a change. Creating the public sphere must be demand-led and not supply-pushed. It will happen, when citizens have real choices about political direction to make.

43 To be precise, the function of a European government covers essentially *exclusive* European public goods. See Collignon, *Is Europe Going Far Enough?*, 2004.

44 The median voter represents the exact middle of a ranking of voters along some issue dimension, e.g. from the most left-wing to the most right-wing.

conditions of any democracy. Should they be impossible in Europe? The answer to Europe's crisis is: Democracy stupid!

The idea of a European government runs into a lot of resistance, not only because vested interests by governments, politicians and the bureaucratic technostructure seek to preserve their power and competences. In a democracy, these vested interests can be overcome, when there is sufficient will and consensus among citizens. After all, politicians usually follow public opinion. But this requires having clear ideas. A major problem is the confusion of states and governments. The main arguments against European democracy are derived from a pre-democratic conception of state sovereignty.[45] States are assumed to be sovereign, exercising undivided power over the people. The "people" are defined as a culturally more or less homogeneous group of citizens who form the nation. The "nation" arises from the lofty edifice of formal and informal rules, regulations, conventions, values, and memories that generate people's feeling of identity, while the nation state is the institutional structure that gives continuity to this feeling. Thus, government is the incarnation of the state, which is the incarnation of the nation. No nation, no state. Given the substantial cultural heterogeneity in Europe, it is therefore impossible to talk about "a European people" as we talk about the French or German people *(le peuple, das Volk)*. Europe may have *demoi*, but no *demos*. Without a European nation, there is no European state. And without state, there can be no European democracy. So the argument goes.

The implicit assumption in this traditional model is that individual *citizens belong to their States*. However, from a modern point of view, "the people" is simply the set of all individual citizens in a given society. Citizens are free and equal agents who belong to themselves. They interact with each other on the basis of private contracts and they conclude collectively the social contract, through which they legitimise the exercise of power in the administration of public goods of which they are the owners. This has two consequences. First, citizens can be simultaneously owners of different public goods that affect them either as citizens of a nation or jointly across the European Union. In this respect, there is no difference between ownership in public or private goods. For example, I can be the owner of my bicycle, my house, unemployment insurance and the Euro. The decisions of reforming unemployment benefits affect people in one country and are therefore a national public good, but interest rates affect all citizens in the Euro area and are therefore a European public good. Secondly, the modern view implies that power and authority must stand

45 Sovereignty is a complex concept and here is not the place to discuss it. My argument focuses on the "internal" dimension of popular sovereignty, which is part of the European heritage since the English Revolutions in the 17th century and found their modern articulation in the American and French revolutions. It contrasts with the "external" dimension of sovereignty, which is prominent in IR theories (see Krasner, *Sovereignty. Organized Hypocrisy*, 1999). Unfortunately, the IR practice of dealing with sovereign states is an obstacle to recognizing the republican dimension of democratic sovereignty in Europe.

for two distinct phenomena: power draws its legitimacy from authority. As a consequence, governments cannot be sovereign. Sovereignty is the authority to set the ground-rules by which power is exercised, and those who can do so legitimately are called 'the sovereign'.[46] Hence, citizens, not governments are sovereign and this is why they can appoint governments as their agents. They draw this authority from the fact that they are free and equal members of society and as such they can agree who should represent them and who should act on their behalf. Abraham Lincoln has famously formulated this modern concept by defining democracy as *government of the people, by the people, for the people*.[47] Note that he spoke of government, not the state. In this modern perspective, a *government is an agent* appointed by the people to implement policies with the intention of managing public goods, the *res publica*. As the owners of public goods, citizens have the right to control governments, and the latter must ensure that they execute the mandate they have received from citizens in accordance with the collective preferences that emerge from democratic life. But if government is the *agent* of citizens, it cannot be the state, which is a broader concept and *includes* the institutional structures through which citizens interact and regulate their relations as "citizens" who are concerned with their *res publica*. It also implies that *states belong to the citizens* and not the other way round.

The idea of splitting agency according to who is responsible for European and national public goods cuts through many objections raised against the possibility of European democracy. Instead of integrating heterogeneous sets of cultures, values, and identities, it focuses on the collective ownership of public goods. While it is true that European integration does not abolish the nation state, nor the *feelings* of identity and belonging to a nation, the deep range of European public goods has generated shared *interests* among citizens. By appointing a European government, European citizens exercise their *rights* as owners of European public goods. This does not require giving up their national identities. It does not imply the creation of a European "superstate", because the nation state continues to regulate the political, cultural and social dimensions of individuals' local living conditions. Our concept of a European government is also far from instituting an all-powerful Leviathan, because it is only responsible for *European* public goods. This focus on the European public goods i.e. on the *res publica europea,* allows us to speak of the European Republic that requires a government. Although the concept shares with federalists the understanding that jurisdictions can exercise power at different regional levels, it is radically different from federalism insofar it does not seek to integrate autonomous nation states into a single federation of states, or melt heterogeneous groups of people into a single nation. In this respect, our model is closer to the ideas expressed by the former

46 Collignon, *The European Republic*, 2003. There is an interesting parallelism between sovereignty in a polity and the lender of last resort in a monetary economy. In both cases there is a final instance, which defines the functional ground rules of the system.
47 *The Gettysburg Address*, Pennsylvania, November 19, 1863.

Belgian Prime Minster, Guy Verhofstadt.[48] The republican approach focuses on the need to integrate the governance for a set of public goods, not people. It maintains that the ultimate authority, the sovereign, is the citizens, who are affected by policy decisions. States can not give up sovereignty, because sovereignty belongs to citizens, not states. Instead, in the European Republic, citizens obtain the right of sovereignty over policy domains that concern them all and where control escapes them today.

The architecture of the European Republic: less is more

Setting up a democratic European government would allow the European Union to overcome the problems of collective action, which are undermining efficiency and legitimacy of policy making in the European Union of 27 or even more Member States. The criterion for delineating the competences of such a government is clear: does a specific policy affect all citizens or not? The range of exclusive European public goods has substantially thickened for member states that have adopted the Euro. The urgency of setting up a European government is therefore much more pressing in these countries than in member states where the externalities of macroeconomic decisions are buffered by exchange rate variations. Not by coincidence has the French government repeatedly called for an "economic government" in the Euro area. However, it has never made clear how such a government is supposed to work. Our analysis has shown that the notion of a mere "economic" government is too narrow. The range of European public goods is much thicker. Even if they are heavily clustered in the economic domain, European public goods are not only arising in the economy. Furthermore, the efficiency of governance is dependent on legitimacy. French officials have never mentioned the democratic legitimacy of their proposed economic government. Democratic policy processes must give citizens a choice over reasonably coherent policy bundles, and not about separate issues.[49] Thus, setting up different agencies for governing separate European public goods would violate the republican logic. Variable geometries for administrating different domains of public goods, e.g. one for money, one for fiscal policy, one for security, one for military issues, may be the joy of intergovernmentalism, but they are incompatible with democratic principles. This leads us to the conclusion that the Euro area represents a critical mass for setting up a European government, although the scope of this government is larger than the economic domain. This institutional framework has the advantage that every member state of the Union (with the exception of the UK and Denmark) is expected to join the Euro area, once the convergence criteria are fulfilled. Setting up a European government for the Euro area implies therefore that it will ultimately cover the whole Union.

48 Guy Verhofstadt, *The United States of Europe* (London: The Federal Trust, 2006).
49 The need of coherence between interacting policies is a powerful argument against direct and in favour of representative democracy. Witness the problems of governing the state of California.

It is also clear, however, that there are Member States in the European Union, who are attached to maintaining their power as independent States. They may not wish to opt for a European government. It has often been argued that the Lisbon Treaty was the last attempt for constitutional change in the European Union for a long time to come. While this may be true for the European Union as a whole, it is also true that the present policy system will not function optimally, even after ratification of the Lisbon Treaty. It may therefore be necessary to deal with the issue of political union outside the Treaty of the European Union. It could be envisaged that a European political union is set up as a separate institution that establishes rules for decision making within the framework of the Treaty of the European Union. This political union must include at least all Member States of the Euro area, given the high degree of exclusive European public goods amongst them. Its Member States would agree on procedures turning the European Commission into a European Government that is accountable to the European Parliament and receives full democratic legitimacy from popular elections. Similarly, they would agree rules for voting in the Council and the Parliament.

If individual Member State refused to join this political union they would obtain certain derogations similar to the Member States of the European Union, who are not part of the Monetary Union. The model could be the relation between the Eurosystem of the ECB and the non-participating national central banks.

The European Union has come a long way since Jean Monnet invented the European Coal and Steel Community. Today the quality of European integration has changed. Euroscepticism and populism are signs that the old is dead, while the new is not yet born. We must recognise this transformation and respond to it by adapting European institutions to the demands of our times, which remain above all democracy for free and equal citizens. We must overcome the attachment to traditional and often pre-democratic attitudes, which are still dominating the discourse of nationalists, Euro-sceptics and are all too often fed by uncritical supporters of the European Union.

Crisis Management vs. Crisis Resolution: The Governance of the EMU and the Future of Exchange Rate Management

*David Marsh**

Abstract

This article argues that a consistency of purpose and action of international exchange rate regimes would be a minimum requirement for any return to a Bretton Woods-style system of exchange rate management. In the author's view, the absence of this precondition was one of the reasons why a return to worldwide managed exchange rates appears remote indeed. The author explains that this is not necessarily a bad outcome. I.e., pegging exchange rates without the wherewithal to support economies that become out of kilter because of structural and cyclical differences would arguably be a retrograde step that would add to rather than obviate the causes of instability in the world economy. There were longer-term questions about the Euro that have been sharpened by the economic and financial crisis. European governments should find comprehensive answers to these questions. Otherwise, the durability of EMU in coming years would not be assured.

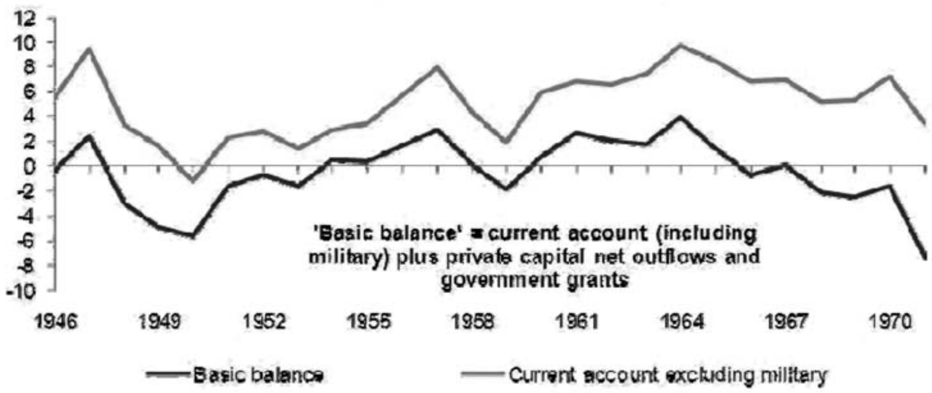
1. The gathering storm – US balance of payments 1968–1973

Among the many factors in the 1960s and 1970s influencing the long gestation that eventually led to the birth of the Euro was European anxiety about the deleterious effects of US monetary and financial imbalances on European currency stability. Allied to this was the view, developed with particularly grandiose effect during the 1960s by French President Charles de Gaulle, that Europe's duty was to encourage the America to "put its house in order" as a means of promoting world currency stability.

De Gaulle's strictures on the "exorbitant privilege" of the dollar (the phrase appears to have been invented during the 1930s by Jacques Rueff) led directly to the French assault on the dollar through sales of excess French dollars for gold at the official price of $35 per ounce during the years when the dollar was damaged by capital outflows after the beginning of the Vietnam war. These sales formed the proximate cause of the suspension of dollar-gold convertibility under President Nixon in 1971.

* The author wishes to thank Gavekal and Lombard Street Research for the charts accompanying this article.

Chart 1
US balance of payments 1946–71, % of GDP



In contrast to the position in the 1990s and (especially) the 2000s, the US current account showed a moderate consistence surplus during this period, although when private capital net outflows and government grants (including for military spending) were taken into account, the "basic balance" turned increasingly negative from he mid-1960s onwards. This formed the centerpiece of the "Triffin dilemma". The US as the main reserve asset country had to run a persistent payments deficit to supply liquidity for expanding world trade. But the dollar debts run up as a result of these deficits formed a heavy burden overhanging the dollar, made countries reluctant to hold the US currency and ultimately destroy trust in gold convertibility.

2. Inflation pick-up after 1967 opens gradual path to floating

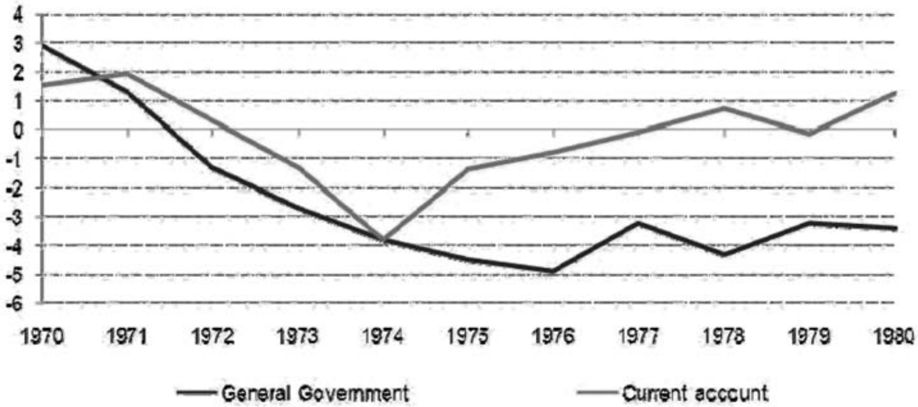
In 1967–71 surplus countries such as Germany blamed the US for exporting inflation – but they enjoyed export-led growth from undervalued pegged currencies. Germany's extreme reluctance to revalue or stimulate domestic demand – although eventually forced on it by sterling and French franc weakness in he late 1960s – was accompanied by increased European dissatisfaction with American economic policies.

Chart 2
Consumer price inflation 1958–70, %

3. Britain's part in Bretton Woods collapse

UK difficulties formed an essential part of the overall strains facing Bretton Woods. Foreigners, especially the US Treasury, reckoned the UK economy was out of control, with budget deficit heading towards 6 percent of GDP. However the current account, deeply in deficit after the oil price explosion, improved as the economy slumped.

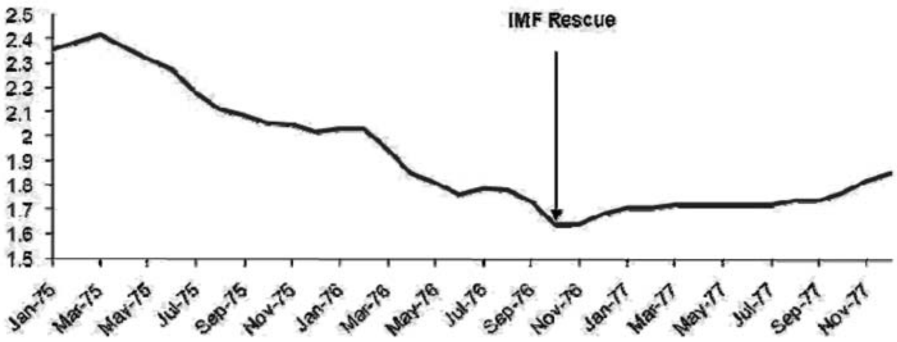
Chart 3
UK twin deficits 1970–80, % of GDP



4. Sterling slump against dollar reversed after IMF package

The pound's recovery after the IMF loans package in 1976 was a sign that economic orthodoxy could pay off under a floating exchange rate regime – an important milestone towards economic policy convergence in the 1980s and 1990s. The IMF demanded harsh conditions, including reductions in public spending and the budget deficit, as well as cuts in money and credit growth. This was a watershed for developed economies – prefiguring a similar change in France seven years later – under which Monetarism replaced Keynesianism.

Chart 4
Dollar/pound exchange rate 1975–77, $ per £1



5. 1980s saw brief attempts at managed exchange rates

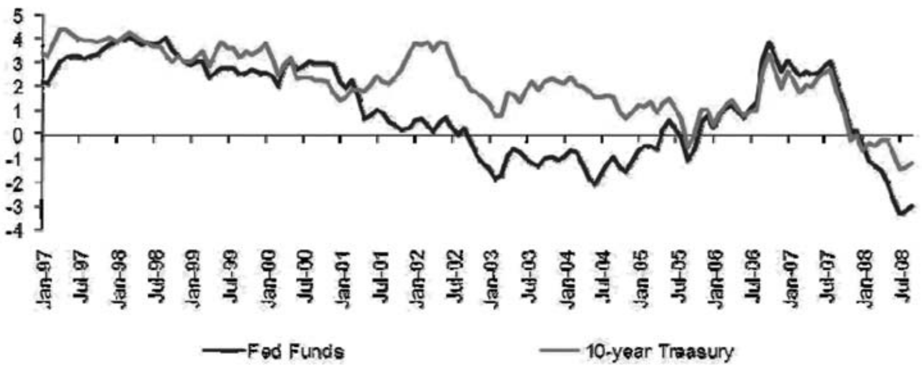
The intellectual and political climate for the development of monetary union was heavily influenced by the experience of dollar volatility in the 1980s, as well as the move to complete the European Single Market by curbing exchange rate fluctuations in Europe. The trade-weighted value of the dollar appreciated by 50 percent in the first half of the 1980s, peaking in March 1985. It had already been falling for several months when Plaza Agreement decided on collective intervention to control the slide The milestone was the Paris Louvre agreement February 1987, signaling developed nations' desire to stabilize the US currency after its fall had become overdone (in fact, it continued to slide until early 1988).

Chart 5
Trade-weighted dollar against major currencies 1979–88, Index 1973 = 100

6. Inexpensive US money makes the world go round

Credit was plentiful as well as cheap in the early 2000s as world liquidity grew sharply and central banks maintained low interest rates in spite of clear risks of 'asset bubbles' in the US and Europe. The search for alternative investment instruments intensified, and techniques of securitisation provided attractive yet complex new instruments in the form of asset-backed securities (ABS), collateralised debt obligations (CDOs) etc. 'Slicing and dicing' allowed banks to create apparently investment-grade assets from sub-prime mortgages and other dubious lending vehicles, while Basle regulatory rules encouraged banks' off-balance-sheet growth, and proliferating models of 'originate and distribute' progressively masked true lending risk

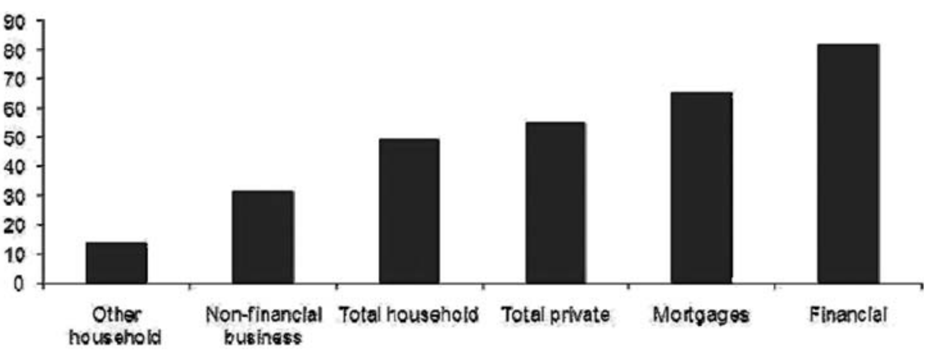
Chart 6
US real interest rates 1997–2008, %



7. US debt accelerates over ten years

US household mortgage and other debt exploded during the 'cheap money decade', with private sector debt climbing to record levels. The near-doubling of financial business debt since 1997 underlined the expansion in balance sheet growth – augmented by off-balance sheet derivatives.

Chart 7
Growth in US private debt, % 1997–2008 Q2



8. World growth on 25-year-long upward path

Cheap credit, the relaxation of world political tensions through the ending of the Cold War, low inflation and rising aspirations for higher living standards throughout the world fuelled a build-up of global growth in 1980–2007. It appeared at the time like good news – but proved unsustainable.

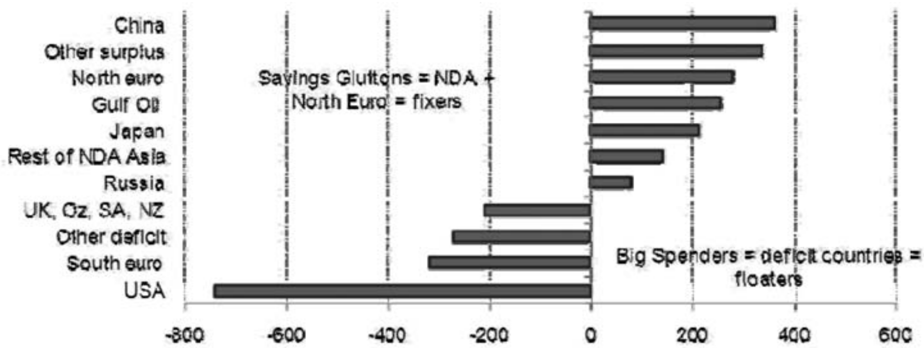
Chart 8
World GDP Growth 1980–2007, %

IMF WEO database

9. The march to massive current account imbalances

A savings glut among the world's surplus countries spawned a spending spree leading to a world boom. A symbiotic relationship developed between borrowers and lenders: without the glut there could have been no spending spree – and without the spree there could have been no glut.

Chart 9
Current account balances, 2007, $bn

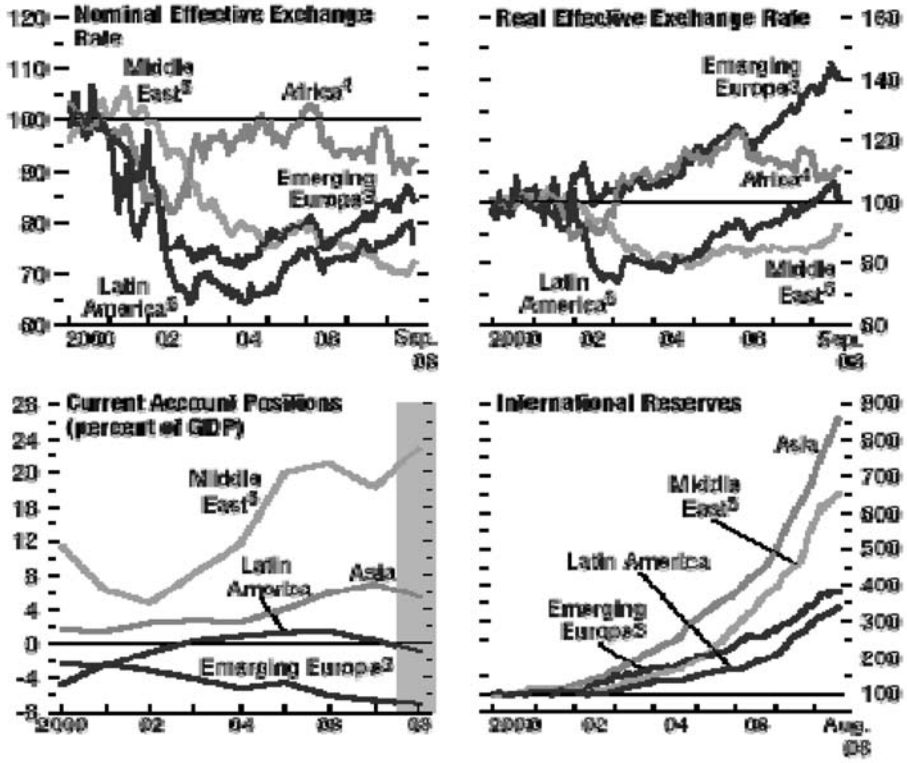


IMF WEO database

10. Worrying build-up of exchange rate imbalances in early 2000s

Real exchange rate imbalances accompanying the balance of payments disequilibrium proved a worrying source of real and potential turbulence.

Chart 10
Changes in nominal and real exchange rates and international economic imbalances



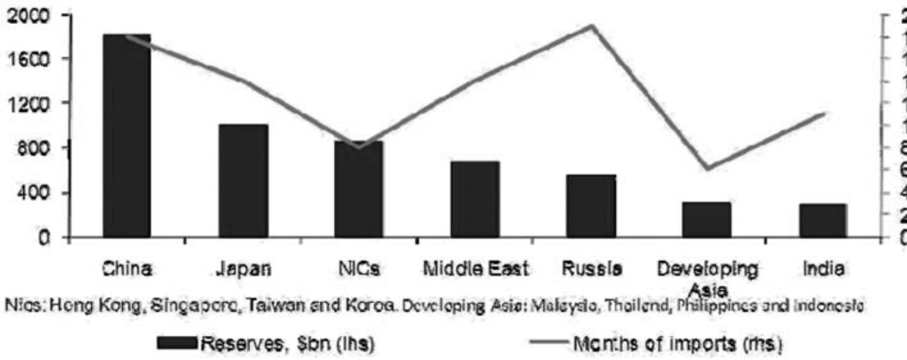
Sources: IMF, *International Financial Statistics*; and IMF staff calculations

11. Extraordinary rise in dominance of New Reserve Holders

A combination of floating and fixed exchange rates led to large build-up in dollar reserves by countries that kept their currencies artificially low against the dollar.

Euro area reserves were comparatively low – a marked difference with the position during the Bretton Woods system.

Chart 11
Levels of foreign reserves and import coverage for key countries (2008)



12. Rapid build-up of US and European current account deficit over ten years

US internal budgetary profligacy, although not a new phenomenon, helped propel US current account deficit to levels well in excess of those (c. 2 percent of GDP) that were previously thought unsustainable). From 2006 to 2008, however, the US current account deficit narrowed by $92bn, despite the threefold increase in the price of oil. In the same period, the Euro area's deficit increased by $98bn.

Chart 12
US twin deficits, % of GDP

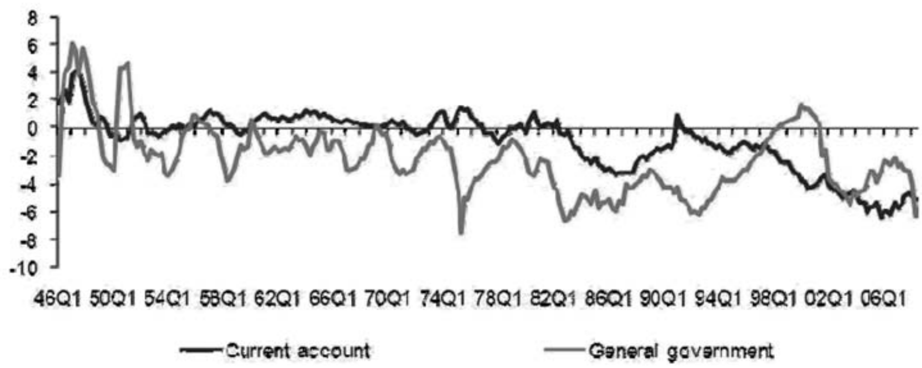


Table 1
World trade slows while external imbalances decline

		2006	2007	2008	2009	2010
Goods and services trade volume		*Percentage change from previous period*				
World trade[a]		9.4	7.0	4.8	1.9	5.0
of which:	OECD	8.3	5.4	3.2	0.4	3.3
	NAFTA	7.0	4.7	2.2	−0.4	2.3
	OECD Asia-Pacific	8.2	7.9	5.5	1.2	5.2
	OECD Europe	9.0	5.1	3.1	0.6	3.3
	Non-OECD Asia	13.0	10.3	7.0	5.2	8.8
	Other non-OECD	9.5	10.5	9.3	3.7	6.3
OECD exports		8.8	6.2	4.5	0.8	3.6
OECD imports		7.8	4.6	1.9	0.1	3.1
Trade prices[b]						
OECD exports		3.6	7.7	8.0	−9.8	1.1
OECD imports		4.7	7.5	10.2	−10.4	1.0
Non-OECD exports		8.2	8.6	12.3	−8.0	1.2
Non-OECD imports		4.7	7.0	10.1	−4.8	1.3
Current account balances		*Percent of GDP*				
United States		−6.0	−5.3	−4.9	−3.9	−3.6
Japan		3.9	4.8	3.8	4.3	3.9
Euro area		0.4	0.3	−0.4	−0.1	0.0
OECD		−1.6	−1.4	−1.5	−1.1	−1.1
		$ billion				
United States		−788	−731	−696	−562	−537
Japan		172	212	187	231	211
Euro area		43	39	−55	−8	−4
OECD		−591	−557	−650	−447	−444
China		250	372	399	437	472
Dynamic Asia[c]		129	175	182	292	340
Other Asia		−17	−34	−40	14	2
Latin America		50	27	−3	−38	−49
Africa and Middle East		289	336	438	−13	−59
Central and Eastern Europe		63	18	33	−28	−35
Non-OECD		763	894	1009	663	670
World		173	336	360	216	226

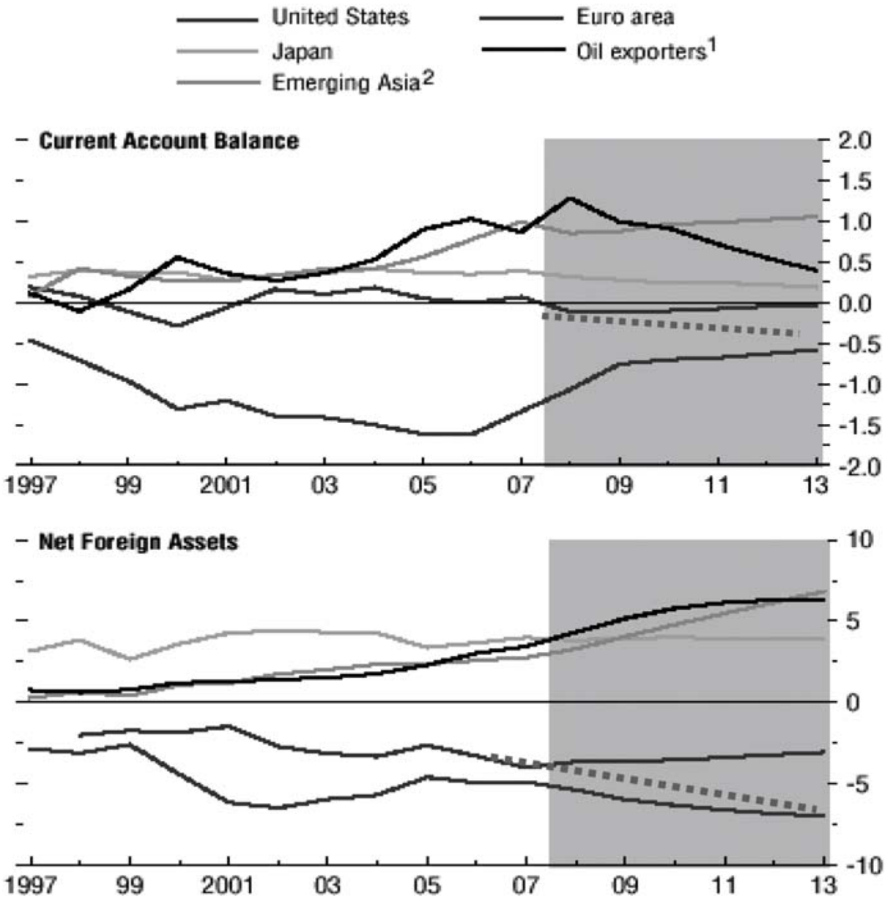
Note: Regionial aggregates include intra-regional trade.
a Growth rates of the arithmetic average of import volumes and export volumes.
b Average unit values in dollars.
c Dynamic Asia includes Chinese Taipei; Hong Kong, China; Malaysia; Philippines; Singapore and Thailand.
Source: OECD Economic Outlook 84 database.

13. Europe current account deficit to narrow less fast than US

Consensus forecasts assume that the US deficit will narrow in 2009 by a further \$100bn, while Europe's deficit will narrow by \$50bn, as oil prices collapse.

Chart 13

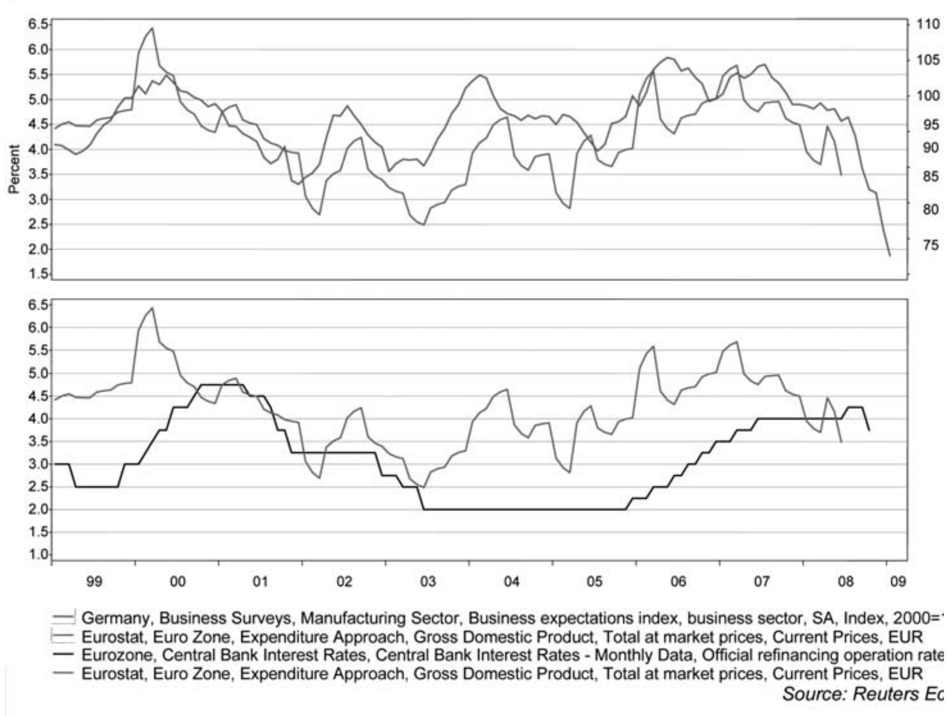
Current account and net foreign asset positions 1997–2013 – past performance and consensus forecasts



14. ECB credibility has been badly affected by 2007–08 unrest

The July 2008 increase in the ECB's lending rate was a significant policy error. The charts showing12-month rate of change of Euro area GDP and short rates (lower panel, in black) show that ECB raised short-term interest rates when EMU entering recession. Short rates have been above GDP growth rate for more than six months – a major factor depressing European growth and an important impediment to ECB credibility. Since October 2008 the ECB has been cutting interest rates in line with actions taken by the Fed and the Bank of England. Particularly in view of worries about inflation (especially in Germany) that appear to be asserting themselves, questions remain how the ECB will respond when the European recession eventually comes to an end.

Chart 14
IFO Survey, Euro zone GDP & ECB Short Rates



15. North-South EMU disequilibrium poses threat to Euro area integrity

Economic divergence between Germany and the Euro area periphery has been increasing as a result of distortions caused by the 'one size fits all' monetary policy.

Table 2
Current account dispersions and implications for Net Foreign Asset (NFA) Position

	Current Account Balance[a]	*Estimated Equilibrium Current Account*	*NFA Position*	*NFA Position When the Current Account Reaches Estimated Equilibrium*[b]
	(2007, in percent of GDP)			
Austria	2.7	1.1	−22	−10
Belgium	3.2	2.5	34	40
Finland	4.6	−0.3	−28	10
France	−1.3	0.6	5	−9
Germany	5.6	2.5	28	52
Greece	−13.9	−4.4	−100	−174
Ireland	−4.5	1.1	−1	−45
Italy	−2.2	−0.1	−6	−22
Netherlands	6.6	2.2	0	35
Portugal	−9,4	−5.8	−80	−107
Spain	−10.1	−5.7	−74	−109

a Data are based on the April 2008 *World Economic Outlook* estimates.
b The estimated speed of convergence implies that 70 percent of the deviation of the current account from the steady state is closed about ten years.
Source: IMF *International Financial Statistics*; and IMF staff estimates.

16. Risk spreads within EMU start to rise

Real exchange rate changes within the Euro area have increased markets' fear of fragmentation and disruption – expressed in build-up of risk spreads on government bonds: an understandable reaction to the crisis. The big question is whether these spreads will grow further in the future as risk sensitivities increase further.

Chart 15
EMU sovereign bond spreads. Greece vs Germany

17. Overall assessment and afterword: Crisis management rather than crisis resolution – The questions EMU must resolve

The experience of EMU does not offer a blueprint for rebuilding the world financial system around a series of "target zones" for major currencies, still less for a return to a Bretton Woods fixed exchange rate system. Instead, EMU shows the risks that can arise when the possibility of exchange rate changes as an instrument of economic adjustment is removed. With the world preoccupied by the task of restoring economic growth and financing countries in balance of payments difficulties, there is no possibility for radical action on rebuilding the world exchange rate architecture in 2009–10. At the same time, the world's response to the downturn has been marred by almost stereotypical differences of economic approach. While Anglo-Saxon economies resort to new Keynesianism, "No experiments" is the Leitmotif in Germany. Prospects for EMU expansion to include countries outside such as Denmark, Poland and Sweden have increased – but so have the risks that EMU could break-up or fragment in the next 10–20 years. Despite increasing pressure on other non-EMU members to join, the UK is unlikely to become a member of EMU until 2025 at least.

The UK, in particular, is guided by a geo-political view of EMU: because monetary union attempts to fuse a potentially highly unstable combination of politics and economics, realising it has been an elusive aim. Yet because its accomplishment is believed to bring such rich rewards, the builders of the single currency have proved, over many years, to be extraordinarily persistent. Even though predictions of EMU's demise or faltering have often been premature, worries over its future stability need to be taken seriously.

The creation of the Euro has broadened and deepened European capital markets just when European governments need to harness the world's savings in the interests of their own well-being. The EMU-wide capital market is now the second biggest area for world savings and investment after the US. All countries in the Euro benefited from a drop in interest rates down to low German levels at the beginning of the single currency era in 1999. The Germans had to share with others the traditional "stability premium" from which they had profited in post-war years as a result of the Bundesbank's anti-inflation success.

However, over the past ten years clearly not all EMU members have made optimal use of these more benign economic conditions. Furthermore – partly as a result of the deep recession – political squabbling is now opening up within the Euro membership about whether governments should benefit from equivalent borrowing conditions in the future. In particular, Germany could face pressure in coming years to revise its attitude on the "no bail-out" clause in the Maastricht treaty which forbids strong economies coming to the fiscal relief of weaker ones.

All these themes are intimately linked to the debate about the style and range of international supervisory and regulatory networks needed to control banking developments across the Euro area and more widely. This is a field which offers plenty of opportunities for national rivalries and jealousies to assert themselves in coming years.

A recent re-assertion of German economic orthodoxy – reflected in tough comments by Chancellor Merkel on the monetary policies of leading central banks as well as by the move in summer 2009 to introduced a "balanced budget" law into the country's constitution – adds up to a shot across the bows of more spendthrift members of the Euro area. And it threatens to expose again a North-South divide between the stronger and weaker Euro countries – a process which, if it proceeds unchecked, could have potentially virulent consequences.

The Future of Exchange Rate Systems: Back to Bretton Woods, forward to a New Bretton Woods?

Wolf Schäfer

Abstract

The revival of a multilateral exchange rate system (ERS) with one single currency and binding global rules for national exchange rate management is not a viable or realistic option. It is more realistic that the present 3-polar ERS in the medium term could dynamically enlarge to a 4-polar – in the long run even to a multipolar – system especially when taking China into account. In this view, the global ERS is likely to be extensively characterised by a small number of competing anchor currencies (currency oligopoly) which floats vis-à-vis each other and to which pegs and managed floats are attached (satellite currencies). Globalisation contradicts international monopolies including monopoly currencies. Globalisation stimulates international competition including anchor currency competition. This article underlines that this is why there is no way back to Bretton Woods or to any similar system based on only one single world anchor currency.

Back to Bretton Woods, forward to a New Bretton Woods – or what?

The global financial crisis with its turbulent effects has brought about international debates concerning a new world financial architecture. Though the origin of the crisis is primarily not to be found in a miscarriage of the international exchange rate regime, calls have been made – here and there – for the shaping of a new Bretton Woods System (BW II) with reference to the old one (BW), which, as is well-known, was designed in 1944 and broke down in 1973.

There is no serious crisis of the international monetary system but rather of the international financial order. Thus, the call for a new BW II should essentially be interpreted as an urgent request for a reshaping of the institutional arrangements regarding the international financial institutions, i. e., the functioning of the national and international money and capital markets. This includes the management of system-related risks by private and state-owned financial institutions and governments.

At the tenth anniversary of the Euro, we should have a short glance at the role of the Euro-system in this crisis: Some non-members (e. g. Denmark and Sweden) are reflecting on the pros and cons of remaining outside of the Eurozone. Some members (e. g. Italy and Spain) occasionally discuss costs and benefits of potential exit options. Due to the crisis, the spreads for state loans increasingly diverge in the Euro area indicating growing economic and political heterogeneities between the members of the Eurozone. It should be stressed that the spreads are currently significantly larger than at the beginning of the Euro area, though not as large as prior to the introduction of the Euro. One main reason for this is the divergent credibilities of Euro-members national screens for their banking systems, stipulating different risk premia.

In order to answer the back-to-BW-question in such a complex European and international monetary landscape after 35 years of empirical experience with the post-BW international monetary order, a short re-evaluation of the basic arrangements of BW is needed.

Basic arrangements of BW

BW of 1944[1] implied principally fixed exchange rates to the US Dollar (USD) as the world anchor currency through intervention obligations of the national member Central Banks (except of the US-Fed) regarding the USD (originally within a +/− 1 percent-band). The USD was irreversibly fixed to gold with an obligation for the USA of convertibility into gold vis-à-vis member Central Banks.

Realignments were allowed only in the case of a country's "fundamental" disequilibrium in its balance of payments. Thus, BW could be termed as system of "step flexibility" of exchange rates with an asymmetric adjustment mechanism. The main function of the IMF was to supervise the system, to give credits roughly within the limits of a member country's quota resp. drawing right, but not to be an international lender of last resort.

BW collapsed in 1971 when the USA suspended the convertibility obligation, and in 1973 – after a short period of floating and following realignments – it was finally substituted by world-wide flexible exchange rates.

The main reasons for the collapse were manifold. In the first place, a significant mismatch of extended aggregates of USD outside the USA to the US-gold stock had been generated due to the fact that the USA as the anchor country was able to invoice any import and foreign investment in USD, i. e., in a currency which the country could create without limit. Thus, the USD world money supply expanded to such an extent that – in combination with the creation of Special Drawing Rights (SDR) in 1970 by the IMF – the world inflation rate increased[2]. As the USA did not correctly play its role of a hegemon in providing a stable anchor currency, a worldwide confidence problem arose and – especially after the suspension of the US convertibility obligation in 1971 – destroyed the basic pillar of the system.

Secondly, there appeared an extended importance of growing international capital flows. The capital balance therefore increasingly came to dominate the trade balance in the countries' balance of payments. This was relevant also for the determination of exchange rates which became

1 Wolf Schäfer, *Währungen und Wechselkurse* (Würzburg, 1981).

2 Michael D. Bordo and Barry Eichengreen, "Bretton Woods and the Great Inflation", *NBER Working Paper* (Cambridge, Mass., 2008).

increasingly influenced by capital movements rather than trade which was in a way opposite to the traditional BW philosophy. This resulted in foreign exchange interventions becoming ineffective and increasingly counterproductive.

Thirdly, exchange rate policy was highly politicised so that realignments were generally carried out too late. This invited frequent low risk one-way speculative attacks and, furthermore, generated increasing disequilibria in the balances of payments, implying problems of structural distortions in the national economies: Undervaluation (overvaluation) implicitly subsidises (taxes) the export and import substitution sector of the economy and implicitly taxes (subsidises) the import sector. Thus, persistent misalignments of exchange rates – which developed as a core feature of the BW-system – principally means protection generating misallocation of national resources.

As misaligned curries had to be realigned sooner or later due to world market forces and pressure of the trade partners, the adjustment costs of distorted production structures in the economies were higher in the step-flexible BW arrangements compared to those in a gradually adjusting exchange rate system.

The international exchange rate system (ERS) today

Since 1973, the international monetary order can be characterised as a world of principally floating exchange rates. Countries are free to choose their own exchange rate policy, there exists no official intervention obligations except for members of regional systems of fixed exchange rates or monetary unions, e. g., the EMU. The absence of intervention obligations does not mean that countries do not intervene casually or even permanently. Free floating is substituted by managed floating. However there is high empirical evidence that foreign exchange interventions are not effective.

Contrary to BW, there exists no single anchor currency. Instead, three major currencies can be identified: the USD, the Euro and the Yen. They float principally against each other being attached by pegs and managed floats of other currencies. As regards pegs, there are various explicit and implicit ones: single peg, basket peg, crawling peg, currency board, dollarisation, monetary union and others. The theoretical and empirical literature on pros and cons of these alternatives is boundless.

Free floats, managed floats and pegs represent the countries' different philosophies as well as the means and ends concerning the ERS. Contrary to BW, three basic options are available:

The first option is between choosing the price level or the exchange rate as a nominal anchor. In the case that the country chooses the price level then the exchange rate is the resulting variable. An autonomous monetary policy and the realisation of seigniorage is possible. If the country fixes the nominal exchange rate as an anchor no autonomous monetary policy is possible and the price level is the resulting variable. Evidently, you cannot have both anchors at the same time.

The second basic option is between a nominal anchor and a real target. The nominal anchor approach implies that real prices produce internal and external equilibrium: real exchange rates, real wages, real interest rates. The real target approach means that the nominal exchange rate is a policy instrument affecting internal equilibrium, i. e., output and employment.

The third basic option implies the political choice between a unilateral and multilateral ERS. The unilateral approach is characterised by a country which accepts the international environment as given. This is relevant mostly for small countries. The multilateral approach means that countries join a system of binding rules. Examples of this are BW and the EMU.

Aspects of modern exchange rate theory and policy

The collapse of BW indicates that this system – and the multilateral succeeding regimes – has combined the disadvantages of fixed and flexible ERS rather than their advantages as was originally intended. Modern exchange rate theory has been developed partly away from paradigms of the BW times.[3] The empirical evidence shows that under certain conditions corner solutions can promote stabilising expectations thus reducing destabilising speculation. Furthermore, corner solutions are recommended within cost-benefit analytical approaches of exchange rate realignments.

These are the main reasons why corner solutions have their high time in theoretical discussions and empirical implementations. Corner solutions represent exchange rate options which refer only to “pure” ERS: either irreversible pegs or totally free floats. The choice of either the first or the latter depends on the size of the economy. By and large, it is theoretically explainable and empirically verifiable that big countries prefer floats whereas small countries choose pegs. This is reasonable if and because

- real exchange rates bear the main adjustment burden to bring about internal and external equilibrium,
- for big countries (relatively small tradables sector) the adjustment costs of changing export and import prices by changing the exchange rate as only one price are less than changing millions of home prices (relatively large non-tradables sector),
- for small countries the situation is the reverse: the implications being that it is less costly to peg the home currency and make a relatively small number of internal prices flexible.

Furthermore, the demand for irreversible corner solutions stems from the well-known confidence problem: Only trustworthy pegs and floats stabilise expectations of international capital disposers and traders. In addition, irreversible pegs, especially currency boards, reinforce the credi-

3 See also Maurice Obstfeld and Kenneth Rogoff, *Foundations of International Macroeconomics* (Cambrigde, Mass., 1996).

bility of a country to gain stability by importing the Central Bank's reputation of the anchor country.[4] This seems to be important, especially for small countries, in order to fight high inflation by a non-gradual strategy and to join a monetary union. Good examples are the exchange rate strategies of the former socialist middle and eastern European countries which, as part of their transformation process, are preparing for the EMU.

Future global ERS architecture

The revival of a multilateral ERS with one single anchor currency and binding global rules for national exchange rate management is therefore not a viable or realistic option. Consequently, this is also true for the Mundell-claim for a universal currency as well as for the proposal of the Chinese Central Bank for a raw material price based anchor currency to deprive the USD or even the proposal for a revival of the importance of the SDR.[5] Monopoly solutions are out of focus: "No single currency regime is right for all countries or at all times" (Frankel).

Thus, it seems realistic that the present 3-polar ERS in the medium term could dynamically enlarge to a 4-polar – in the long run even to a multi-polar – system especially when taking China into account.[6] This is likely to happen because the necessary conditions for becoming a leading currency imply a high share of world output, trade and capital flows in combination with an economic policy which is stability- and liberalisation-oriented.

China is still in great deficit. However as the country is already fast approaching the strategy of expanding its political and monetary influence in Asia by increasing the attraction of the Yuan as invoice currency for Asian traders, capital disposers and investors, China is sooner or later forced to liberalise its trade and capital arrangements. In the same sense this also refers to a number of Arabic countries of the Middle East which are urgently striving to create an Arabic currency area in order to obtain more independence, especially from the USD.

As a result, the global ERS is likely to be extensively characterised by a small number of competing anchor currencies (currency oligopoly) which float vis-à-vis each other and to which pegs and managed floats are attached (satellite currencies). Globalisation contradicts international monopolies – including monopoly currencies. Globalisation stimulates international competition – including anchor currency competition. This is why there is no way back to BW or to any similar system based on only one single world anchor currency.

4 i.a. Torben M. Andersen and Julia Chiriaeva, "Exchange Rate Pegs, Fiscal Policy and Credibility", *Open Economies Review,* 18 (2007): 53–76.

5 Zhou Xiaochuan, "Reform the International Monetary System", 2009, www.pbc.gov.cn/english/detail.asp?col=6500&id=178 (accessed 13 August 2009).

6 Wolf Schäfer, "China's Exchange Rate Policy in the Light of the German Experience with an Undervalued Deutschmark", in *Competition and Partnership – Key Issues of Economic and Trade Relations between China and EU,* ed. Shi Shiwei, 66–74 (Beijing, 2008).

Authors and Editors

Pervenche Berès, Chairwomen of the Committee on Economic and Monetary Affairs of the European Parliament at the time of the conference, now Chairwomen of the Committee on Employment and Social Affairs, and Rapporteur of the Special Committee on the Financial, Economic and Social Crisis

Rolf Caesar, Professor (emeritus), Chair of Public Finance, University of Hohenheim, Stuttgart

Stefan Collignon, Professor of Political Economy at the Sant'Anna School of Advanced Studies, Pisa, and Chairman of the Scientific Committee Centro Europa Ricerche (CER), Rome

Werner Ebert, Head of the "EPC Presidency" Unit and responsible for European and international economic policy in the German Federal Ministry of Finance

Christian Kastrop, President of the Economic Policy Committee of the EU and Deputy Director General for Public Finance and Economic Affairs in the Federal Ministry of Finance, Germany

Hans-Helmut Kotz, Member of the Executive Board of the Deutsche Bundesbank, Frankfurt am Main

Wim Kösters, Professor at the Faculty of Economics, University of Bochum

Karel Lannoo, Chief Executive Officer, CEPS, Brussels

Martin Marcussen, Professor at the Department of Political Science, University of Copenhagen

David Marsh, Chairman, London and Oxford Group, London

Wolf Schäfer, Director of the Europa-Kolleg Hamburg, Professor em. of Economics of the Helmut-Schmidt-University Hamburg

Holger Schmieding, Chief European Economist at the Bank of America Merrill Lynch

Daniela Schwarzer, Head of Research Division "EU Integration", Stiftung Wissenschaft und Politik SWP/German Institute for International and Security Affairs, Berlin

Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, Frankfurt