Redesigning European Monetary Union governance in light of the eurozone crisis

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CONTENTS

INTRODUCTION 5

Andreas P. Kyriacou

THE EUROZONE CRISIS: THE BIG PICTURE 11

Loukas Tsoukalis

THE ECONOMIC AND MONETARY UNION AND ITS EVOLUTION SINCE THE CRISIS 21

Elena Flores and Kees van Duin

BUILDING A SUSTAINABLE EUROZONE 35

Federico Steinberg

EMU GOVERNANCE AND THE LIMITS OF FISCAL POLICY COORDINATION 47

Cinzia Alcidi and Daniel Gros

CAN THE EUROZONE'S ECONOMIC GOVERNANCE COMBINE POLITICAL ACCOUNTABILITY, LEGITIMACY AND EFFECTIVENESS? 57

Fabian Zuleeg

EMU GOVERNANCE: BETWEEN *DEMOI* AND *KRATOI* 67

Yves Bertoncini

TECHNOCRATIC GOVERNANCE VS. POLITICAL ACCOUNTABILITY IN EUROPE 79

Ulrike Guérot

INTRODUCTION

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When political leaders met at Maastricht in December 1992 and took the historic decision to create the EMU, they were responding to several challenges. First, the gradual liberalisation of capital movements that was necessary to complete Europe's single market made it increasingly difficult to stabilise exchange rate fluctuations in the context of the European Monetary System (EMS). Second, the weight of the German economy and the credibility of the German central bank meant that the functioning of the EMS was increasingly dominated by German monetary policy. Related to this, significant stress was placed on the EMS by German reunification, which both increased the relative size of the Germany economy and made the adoption of a contractionary policy by the Bundesbank necessary. In light of this, the creation of a European central bank was seen by some as a way to dilute German monetary dominance. Finally, just as European integration was envisaged as a necessary complement to a stronger Germany in the context of the Cold War, German reunification increased the need to move on with the process of economic and political integration across Europe.

The single currency was therefore seen as a way to eliminate exchange rate uncertainty in the single market and an opportunity to both reduce German dominance in monetary affairs and anchor a newly reunified Germany within the European Union. While not denying the importance of these factors in the decision to create a single currency, the final design of the European Monetary Union was, in fact, very much inspired by German concerns that the new currency area should place a tight lid on inflationary pressures. This explains the establishment of the convergence criteria and the Stability and Growth Pact, the former aimed at keeping high-inflation countries out of the euro and the latter put in place to ensure that euro members avoid irresponsible (inflationary) fiscal policies. It also explains why the European Central Bank's statutes enshrine price stability as the primary objective and forbid the bank from taking instructions from and lending to national governments or European institutions.

The current euro zone crisis and, specifically, the depth and duration of the economic recession in some euro member states, has created the necessity to debate whether the original design of the euro was fundamentally flawed and, if so, what can be done to improve the governance of the EMU. A one-size-fits-all monetary policy and poor national supervision of the banking sector in Greece, Ireland, Portugal, Spain and Cyprus meant high levels of private debt and asset price bubbles in these countries. This set the stage for a full-blown banking and liquidity crisis as the ripples of the subprime mortgage shock in the US reached the euro area. Affected countries found it increasingly difficult to respond to the subsequent bust by way of public spending financed through bond issues and were forced to turn to the ECB, the European Commission and the IMF for financial assistance. In exchange for this assistance, the troika has imposed fiscal austerity programmes on recipient countries, which has been criticised for prolonging the economic downturn in each. With this in mind, many of the contributions in this monograph review flaws in the basic design of the euro and propose ways to improve the governance of the euro area.

Another important question this monograph tries to illuminate is the extent to which the design of the European Central Bank – which put a premium on independence from political pressures – has widened the democratic deficit in Europe. Ever since the European Union was created, commentators have voiced concerns about the democratic legitimacy of the process of ever deeper economic integration – a process which is generally perceived to be driven by politically unaccountable technocrats. The issue of political accountability has emerged with particular force in those member states obliged to adopt fiscal austerity during the great recession in exchange for receiving financial assistance from the EU. Arguably, the democratic deficit has been widened in the euro area, given the statutory independence of the ECB and the adoption and application of the bail-out programmes by the troika. Political accountability is, of course, important insofar as it contributes to the legitimacy of deeper integration in the eyes of citizens. But on the other hand, independence from political pressures may be important for enhancing the credibility and, ultimately, the effectiveness of economic policy reforms (in economic jargon, to minimize time inconsistency). In this context, the last two contributions specifically reflect on governance reforms in the euro area from the perspective of democratic accountability.

The monograph opens with a contribution by **Loukas Tsoukalis** who locates the origin of the euro zone crisis in the deregulation of US financial markets and the ensuing bursting of the financial bubble there. He emphasises how the basic design of the euro made it unable to withstand the resulting negative shock to the European economy. The Stability and Growth Pact was clearly not enough to avoid the build-up of imbalances and was too restrictive in the face of the crisis. He explains how the crisis, which has been especially deep in the southern European members of the euro zone, has deepened North-South divisions in the EU along a creditor-debtor divide and argues that the brunt of the adjustment has been born by the latter and that, arguably, creditor countries share at least some responsibility for generating economic imbalances in debtor countries. He warns that the application of austerity and reform policies in the south has led to disenchant-

ment there, fuelling the ascent of populist parties. But populism is not the only ideology on the rise in Europe, according to this scholar. Nationalism is also gaining strength in some member states in response to immigration and the loss of sovereignty due to European integration and, more broadly, globalisation. In response to these developments, Tsoukalis calls for a new European grand bargain consisting of national reforms and policy and institutional changes at European level.

Elena Flores and Kees Van Duin begin their article by identifying the depth of the economic crisis and its differential impact across the euro area due to the distinct economic realities of each member state. The authors argue that the impact of the crisis was partly due to the poor application of existing rules: an insufficiently supervised Stability and Growth Pact prior to the crisis led to problems of fiscal sustainability; the supervision of national banking sectors by national central banks was weak; and insufficient structural reforms in some euro area countries put a brake on necessary economic convergence. They then review a series of policy reforms and initiatives taken since the crisis, including the creation of the European Stability Mechanism, the adoption of the Outright Monetary Transactions programme by the European Central Bank, the strengthening of the Stability and Growth Pact by way of the "six-pack" of legislative proposals from the Commission and several initiatives, for example, the Single Supervisory Mechanism, which together amount to the assignment of banking supervision to the European Union. The authors argue that while these measures are necessary for the better functioning of euro area economies they are not sufficient. Reductions in public and private indebtedness must continue and need more time, unemployment and poverty are problems in themselves but they also pose threats to fiscal sustainability and economic growth in the long term, and financial markets remain fragmented. They end by arguing in favour of continued structural reforms in product and labour markets, continued fiscal consolidation and the completion of the banking union in order to ensure the correct supervision of the banking sector.

Federico Steinberg reminds us that the euro was created with the aim of improving the prosperity and stability of its members and as one step in the process of creating "ever closer union". Though the euro worked reasonably well while member economies were growing, the global financial crisis and the ensuing debt crisis on the European periphery has brought the euro to the verge of collapse. In response to this, the author proposes a set of concrete and interconnected reforms aimed at improving and strengthening the governance of the single currency. These include steps towards fiscal union (with fiscal transfers, as suggested by optimum currency area theory), macroprudential and banking policies (full banking union that includes effective macro-prudential supervision and a credible insurance deposit scheme), and economic union to promote structural reforms so as to attain the necessary economic convergence. Steinberg makes specific proposals in relation to each of these three steps, identifying both the strengths and weaknesses of current arrangements. Because movement on all these fronts means the continuing erosion of national sovereignties, the author underlines the need to make further advances in the process of political union in the form of direct elections of European leaders as a way of legitimising the whole process.

Cinzia Alcidi and Daniel Gros turn to the issue of fiscal policy coordination in the euro area. They explain that, in the absence of cross-country fiscal transfers from a common pool of centralised resources, fiscal coordination is seen as an optimal tool for dealing with spillover effects emerging from country-specific fiscal policy changes.

They identify how the constraints on national economic policies through coordination are positively related to the risk of spillover effects: the constraints range from coordination and surveillance of fiscal and macroeconomic policies in cases of low spillover risk all the way up to the implementation of macroeconomic adjustment programmes in the event of high spillover risk. The authors are careful to point out that the current institutional set-up of the euro does not account for the fact that the long-term goal of fiscal sustainability may conflict with the need to expand aggregate demand in the medium to short term. Finally, they explain how the optimal design of fiscal coordination crucially depends on the state of the economy, since the latter determines the size of the spillover risk.

Fabian Zuleeg describes several limitations of the EMU's governance framework, which relies on a rule-based approach characterised by sanctions for non-compliance. These include questions about the choice of appropriate rules, the rigidity of the framework in the face of unanticipated shocks and the credibility of enforcement mechanisms. The author moreover emphasises that crisis management in the EU does not pay sufficient attention to political developments in member states. Thus, in the face of rising populism in countries faced with falling living standards, the EU's strategy must be sensitive to the need to create local constituencies and provide "realistic prospects of future improvements". Zuleeg further identifies a prisoner's dilemma at the heart of EU policy: in the current climate of distrust between member states due to the euro crisis, those countries needing reforms also require support from the others, but the latter are not willing to provide this in the absence of reforms. This situation brings to the fore the role of third-party arbitrators acting as honest brokers. Traditionally, this role has been played by the European Commission but, Zuleeg argues, its capacity to do so has been reduced by its increased politicisation. One way of getting around this problem is to outsource functions that call for impartial arbitration (competition policy, monitoring of fiscal policies, a statistics agency) through the creation of independent bodies. Fabian Zuleeg ends his contribution by recognising the need to put in place mechanisms that enhance democratic accountability and thus legitimacy. This is the main theme of the last two contributions in this monograph.

Yves Bertoncini begins his contribution by underlining that the different protagonists in the euro crisis face different democratic constraints. The troika's accountability is very weak, while the European Central Bank is politically accountable only in the context of its dialogue with the European Parliament. Alternatively, the European Council is accountable to national parliaments and/or citizens, making it difficult to reach compromises at European level and explaining why at times the Council has decided "too little, too late". He classifies the interactions between the European Union and its member states into four different regimes: an IMF regime under which member states have an obligation to both achieve results and to do so in a specific manner; a UN regime where

this obligation only extends to results; a hyper-OECD regime wherein the EU formulates non-binding recommendations; and a World Bank regime which ties financial aid to structural reforms. In this context, the author makes a series of proposals aimed at strengthening the accountability of EMU governance, including regular summits in the euro area and endowing the Eurogroup with a full-time president. In the same vein, Bernoncini ends with a set of concrete steps aimed at increasing national parliamentary control over members states' European policies such as a euro area sub-committee in the European Parliament and an inter-parliamentary conference for the EMU.

The monograph ends with a contribution by **Ulrike Guérot.** She invites us to consider the governance versus accountability dichotomy from a different perspective. She points out that the general assessment in Germany is that the euro crisis is at an end as the European periphery recovers from austerity. But she doubts this is the case in Spain, Italy and, especially, Greece. Proposals to improve democratic accountability in euro zone governance, are, according to this thinker, misguided. They originate from a vertical framing of the issues, leading to debates about more or less Europe. Those who want more Europe support strengthening supranational institutions, while those who oppose this want to strengthen national parliaments. Guérot argues in favour of a horizontal framing of the issues or a transnational perspective based on equal European citizenship. So, for example, we should reframe the discussion between "debtor and creditor countries within the eurozone… not as a question of interstate solidarity but as a political question of redistribution". The author ends with several policy suggestions, aside from abandoning the more/less dichotomy. For example, she calls for greater emphasis on input (for which, read: democracy) rather than output legitimacy. Or a shift from state legitimacy to citizen legitimacy, thus questioning the asymmetric power distribution in the European Council or, in other words, German dominance there. In summary, Ulrike Guérot challenges us to abandon the concept of European integration and focus our attentions on how to increase the quality of European democracy.

All in all, the articles included in this monograph improve our understanding of both the economic and political dimensions of the euro zone in light of the current crisis and as such should help inform efforts to improve EMU governance.

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Europe has been in deep crisis for several years. It is the worst economic crisis since the end of the Second World War and certainly the worst crisis of European integration since the very beginning. The eurozone is at the centre of it, although the crisis extends much beyond the currency union of (now) 19 members and goes much deeper. It also manifests itself in many different ways[1].

The crisis in a nutshell

Let us start with the economic dimension. European economies have been languishing and some, indeed, have imploded. The eurozone as a whole will not regain the level of its real 2007 GDP before the end of 2015 at the earliest: a lost decade in other words. It has only been marginally better for the EU-28. Average unemployment remains in double-digit figures, and in the south of Europe it has reached levels that would have been unimaginable during peacetime. In the worst-affected countries, youth unemployment has risen to stratospheric levels and is unlikely to come down fast anytime soon, raising the spectre of a lost generation.

In a crisis that was born in the USA, comparison with the United States in terms of macroeconomic performance is highly unfavourable for the eurozone. The same is also true of comparison with the UK in more recent years. Of course, averages can be misleading and this has been even truer during the crisis. Economic divergence has grown a great deal between and also within European countries during the crisis. This is a problem in itself because economic divergence leads, in turn, to a divergence of interests and perceptions and hence to greater difficulties in the adoption of a common stance with respect to the crisis.

At one end of the eurozone spectrum stands Greece, a country that has lost a quarter of its GDP. It finds itself in the sad company of the other southern European countries and Ireland that have also experienced negative rates of growth during this period, although none as bad as Greece. At the other end of the spectrum is Germany, the country that

1. This paper draws on Loukas Tsoukalis, *The Unhappy State of the Union: Europe Needs a New Grand Bargain* (London, Policy Network, 2014): http://www.policy-network.net/publications/4602/The-Unhappy-State-of-the-Union For the Spanish translation, see: http://www.realinstitutoelcano.org/wps/portal/web/rielcano_es/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_es/zonas_es/europa/tsoukalis-triste-estado-de-la-union-europa-necesita-nuevo-gran-pacto

has emerged as the indisputable leader of the eurozone and the EU as a whole in times of crisis. The German economy has certainly not thrived during this period, but everything is relative. By comparison with most of Europe's periphery, Germany has done very well indeed. For most Germans, the crisis remains something terrible that happens to others.

Europe has been divided and its divisions run deep. Citizens in creditor countries resent risking their savings to save eurozone partners in trouble, partners at least some do not consider worth saving. Those in debtor countries see the EU as the policeman of austerity and economic hardship. They have also discovered that there is little room for democracy and sovereignty when you are on the verge of bankruptcy, which has caused a great deal of resentment. As for the others in the rest of Europe, they feel marginalised in a union where membership of the euro determines the core group, albeit an unhappy one.

Within countries, the income gap has widened further and centrifugal forces have grown stronger. There is a great deal of public discontent, especially in the worst-affected countries. Much of this is now being channelled through anti-system parties: Syriza in Greece, Podemos in Spain, and Sinn Féin in the Republic of Ireland. On Europe's periphery, protest mostly takes a left-wing form, though with an undoubtedly populist underpinning. Radical politicians in those countries argue for a different kind of Europe, although still in rather vague terms.

Anti-system parties have been gaining strength in other European countries as well. The centre is being squeezed almost everywhere and the extremes are widening. In France and the UK, inside and outside the eurozone, respectively, most of this anti-system vote seems to be driven mainly by popular concerns about immigration and the loss of sovereignty. Front National and the UK Independence Party are nationalist, right-wing and anti-Europe. This is a very different kind of anti-system protest. As for Italy, it sits uncomfortably in between—Cinque Stelle is arguably a case on its own, while Lega Nord represents right-wing populism that is also anti-EU.

Along with populism, nationalism is growing across Europe: the two often go hand-in-hand in search of convenient scapegoats and the EU offers itself as the natural candidate. In the European Parliament elections of May 2014, anti-European parties registered a large increase in their share of the vote in countries such as France, the UK and Denmark, above all. But these parties are still in a minority, representing about 25 per cent of MEPs.

Meanwhile, support for European integration has sunk all around, as successive surveys made by the Eurobarometer and others indicate. However, what is remarkable is that support for the euro remains relatively high, including in the beleaguered countries of the European south. Is there a contradiction between the two? I suggest that the explanation is rather simple. Support for European integration has always very much depended on the perceived capacity of the European project to deliver the goods. It has not been delivering for some years now. But then, what about the support for the euro? Clearly, this is less out of love for the common currency than fear of the alternative. The majority of Europeans are unhappy with the status quo and the way the

crisis has been managed or mismanaged especially within the eurozone. But they also believe that leaving the common currency now would make things even worse, and they are most probably right.

Different dimensions of the crisis

Why have we done so badly? The answer is neither simple nor one-dimensional. It has to do with the size and nature of the crisis, with the fact that the Maastricht construction was both weak and unbalanced, with different kinds of national failures, and, last but not least, with an economic strategy that is deeply flawed. Let us briefly examine each one in turn.

Trying to understand the crisis in its multiple dimensions and manifestations is like playing with Russian dolls: you take one, open it and find a smaller one inside, and so on. The trouble in this case is that each doll is uglier than the last.

The biggest financial bubble since the great depression burst in 2008. Private and public debt had been rising for many years, helping to preserve levels of consumption in the West (and the careers of some politicians) that were clearly unsustainable in the long run. Deregulated financial markets grabbed an ever-increasing slice of the economic pie, and their operations increasingly resembled those of a casino. The international recycling of funds continued as long as China, the emerging economic power, remained strongly attached to its export-led growth model sustained by an undervalued currency.[2] It was good for many while it lasted. But the bursting of the bubble represented a huge failure of markets and institutions and was a big blow to the neo-liberal orthodoxy in both its political and academic incarnations.

What began as a large-scale financial crisis in the West, starting in the United States, soon transformed itself into an existential crisis for the European currency union. Greece became the catalyst for this transformation, despite its relatively small size (it represents only about 2% of eurozone GDP). At the time, Greece had the worst combination of three different deficits, namely, a large budget deficit added to an already huge public debt, an equally large, indeed unsustainable, current account deficit (a deficit of competitiveness, in other words), and a serious credibility deficit as people realised that Greek politicians had been economical with the truth and creative with the use of statistics, hence the term that was coined: 'Greek statistics'.

The rest of the eurozone initially chose to believe that Greece was unique, which was a way of shutting their eyes to hard reality. All were soon to discover, to their horror, that other members of the eurozone had also tried to live on borrowed time and money within their own privately-created bubbles, and that much of the European banking system was in deep trouble as a result.[3] Since then, European political leaders have shown a strong survival instinct each time they have been faced with the abyss, but precious little strategic vision.

Money was easy and cheap in the years of plenty that preceded the crisis, and much of it was provided by German banks recycling the large current account surpluses and savings accumulated in their home coun-

2. See also the excellent book by Wolf (2014).
3. See Pisani-Ferry (2014), and for a more radical approach, see Streeck (2014).

try. Meanwhile, Germany had set a standard in terms of wage and price increases inside the eurozone that would have been extremely difficult, even with the best of intentions, for other countries to follow. Some did not even bother trying and went partying instead.

The crisis revealed all kinds of national failures within the eurozone. There is a Greek crisis, a Spanish crisis, an Irish crisis, an Italian crisis, and more; they are all different from each other but also part of a systemic crisis of the eurozone. The bursting of the big bubble has revealed the fundamental weakness of the Maastricht construction: European leaders decided to create a common currency without providing it with the necessary institutions and instruments to make it viable in the long run.

The constraints on national fiscal policies through the Stability and Growth Pact never worked properly, and even if they had done they would have failed to prevent the problems in Spain and Ireland. There were no automatic stabilisers in Europe's economic and monetary union nor were there any proper instruments to deal with an emergency, largely because of the fear of the so-called moral hazard. In other words, when the fire broke out there were no fire extinguishers around because some people thought that was the way to prevent fires in the first place. There were no common instruments to deal with the crisis in the banking sector and no legitimate political base on which the Maastricht construction could safely rest. It is a currency without a state, or even the semblance of a state, as Tommaso Padoa-Schioppa (2004) warned us some years ago.

Lessons from history

Geopolitics and German unification were the driving force behind the signing of the Maastricht treaty. President Mitterrand insisted on monetary union in order to prevent a strong, reunited Germany from dominating the European scene. The old logic of Robert Schuman was therefore applied once more: a French initiative to deal with a new German problem, this time employing economic means to achieve political objectives. And Chancellor Kohl agreed, following the same logic as his predecessors. Yet, if people had read the earlier history of European monetary integration more carefully, they might have thought differently at the time.

I believe that the experience accumulated over several decades suggests that Germany enjoys a big structural advantage within a European system of fixed exchange rates. Its economic size and prowess, combined with a decades-long history of stability-minded policies and export-led growth and a corporatist tradition and largely consensual politics have ensured its position as leader. This is precisely what happened with both the snake in the tunnel in the 1970s and the European Monetary System later on (Tsoukalis, 2005).

As long as a European monetary union operates as a modern version of the gold standard, with the European Central Bank making the difference (but not enough difference) and with Germany setting the policy priorities, several countries will continue to find it very difficult to cope after having relinquished their right to devalue and the right to monetise their public debt.

In previous European exchange rate arrangements, Germany quickly ended up determining the policy priorities and, as a consequence, some countries found it increasingly difficult to adjust and eventually had to leave. German leadership thus led to shrinking membership. With the eurozone, it has not been quite the same. True, Germany has once again ended up as leader, but so far membership has continued to grow.

From eleven members when it all began in 1999 there are now 19, with three joining since the crisis broke out. But, of course, with the common currency the stakes are now much higher: it is one thing to leave an exchange rate arrangement, such as the 'snake' or the EMS, and another thing altogether thing to contemplate a return to a national currency that would need to be created *ex nihilo*. In addition, there are geopolitical factors associated with the monetary union, as the Baltic countries would be the first to testify. Nobody can yet say for sure that the euro is here to stay, given the economic and political tensions within it. This is not the end of the story, yet.

Wrong economic strategy

All kinds of 'unthinkables' have happened to save the euro thus far. The list is long and impressive, ranging from big national 'bail-outs' that dare not speak their name because they were not supposed to happen, large packages of financial assistance that have set new records in international financial history, extremely painful adjustment programmes for the countries in trouble with the direct involvement of the IMF and new, stringent forms of fiscal and economic policy coordination for all euro members that have taken Europe's joint management of interdependence into completely new territory.

Meanwhile, the European Central Bank, the federal institution *par excellence*, has continually been forced to stretch the limits of the legal constraints imposed on it by the Maastricht treaty, trying to act as the saviour of last resort for the euro. And there is more. A banking union will be the next most important step after the creation of the common currency. It has been agreed upon and is now being implemented, although the mutualisation of risk will take longer.

All in all, the crisis has already forced euro members into a much more advanced stage of policy integration. Many people already argue that it will not be enough.

The politics of managing the euro crisis has been very much about who pays the bill, although most people directly involved have always pretended otherwise. Economics has also got mixed up with morality. Remember that in German and other languages, debt and guilt are the same word. But are borrowers the only ones to blame when a bubble bursts? And what do you do when debts become unsustainable? Do you just try to buy time, and for how long?

The economic strategy adopted has centred on austerity and reform. It has been dictated by creditor countries led by Germany as a pre-condition for the provision of financial assistance to debtors. But the trouble is that when fiscal contraction happens simultaneously in several coun-

tries while the private sector, including banks, is deleveraging after the bursting of a big bubble, you are likely to end up with a vicious circle of austerity and recession. And then, private and public debt becomes increasingly unsustainable. This is precisely what happened in the eurozone, although in varying degrees from country to country. Meanwhile, the loosening of monetary policy has always been too late and not gone far enough.

Structural reform constitutes the second pillar of the economic strategy. One problem with it is that it takes time to deliver, while the political costs are immediate. Furthermore, structural reform is like a big basket filled with many different items meant to cater to many different tastes. Some reforms, notably in labour markets, mean difficult trade-offs and have broad distributional consequences.

For example, as a result of the labour reforms introduced by Chancellor Schröder, Germany has become more competitive but also more internally unequal. The trade-off between competitiveness and social cohesion is not an easy one to handle politically. Liberalisation alone is not always the answer to everything. At least, let us not pretend that all reform is for the best in the best of all possible worlds. It is also politically much more difficult when you put your foot on the fiscal brakes at the same time. Political leaders in southern Europe can testify to that.

Who pays the bill? The burden of adjustment has so far fallen almost entirely on the debtor countries, with the weaker and more vulnerable members of society being most affected. Rightly so, some people will argue, since those countries were trying to live beyond their means. But they have been punished hard. They have had to borrow large sums of money and the debt accumulated will hang over younger generations for years to come. On the other side of the deal, taxpayers in creditor countries have undertaken significant credit risks by lending to partner countries in trouble, and they are not at all sure to get all their money back. This is a north-south division in Europe.

Private creditors, banks in particular, stand in the middle. With some exceptions, they have been protected with money and guarantees from national taxpayers and European institutions. Not surprisingly, many people in both creditor and debtor countries are manifestly unhappy about the way the pain has been distributed within countries, not just between countries. And this hardly corresponds to the way the gain was distributed before the crisis.

Where do we go from here?

With the benefit of hindsight, we must recognise that the euro was a terrible mistake, at least the way it was done. The state we are in today recalls the old joke about the man who loses his way in the Irish countryside and asks a local for the way to Tipperary. "If I were you, I wouldn't start from here", is the reply he gets. This is where we are today. Clearly we were not prepared for the euro in political or economic terms, and we have committed serious policy errors in the process. But exiting now would be an even bigger mistake. The options are indeed limited and none is easy.

Proponents of the existing economic strategy have pinned their hopes on growth that will bring our economies out of a long recession. Instead, after a lost decade, the eurozone is now courting deflation and growth remains very slow and uneven at best. Both private and public investment are low, the large numbers of unemployed are not expected to find jobs anytime soon, public debt is much higher now than it was at the beginning of the crisis, private debt remains very high and banks are still trying to deleverage: it is a rather gloomy picture.

Unless we find a way to restore growth – sooner rather than later – the risk of a major accident should not be underestimated. Such an accident is more likely to happen through democratic processes than through markets. Economic deadlock and public discontent could eventually force one or more countries to leave the euro. It would be a repetition of what happened with earlier attempts at monetary integration in Europe.

In order to avoid an eventual breakup, we may need a new European grand bargain consisting, first of all, of wide-ranging national reforms combined with a more active use of fiscal and monetary policies, in order to pave the way for bolder measures to be taken later on to deal with the basic contradiction of a currency without a state. As it stands today, euro governance is neither effective nor legitimate. But that story requires another paper, if not a book.[4]

The big picture

The problems of the eurozone are substantial and no simple solutions present themselves. Yet we should not lose sight of the bigger picture. The crisis extends far beyond the eurozone and also goes much deeper. Let us attempt a rough sketch.

We may start with the growing disconnect between economics and politics in our countries. While the economic reality has, over the years, become increasingly global or European, politics has remained stubbornly national or local. How do we reconcile those two realities, and at what cost?

Europe has for a long time tried to produce an innovative answer to this question through the joint management of interdependence and shared sovereignty, and is surely far ahead of any other region in the world in this respect. However, judging from popular reactions today (but also earlier on: remember what happened to the constitutional treaty some ten years ago?), the European answer leaves much to be desired. Of course, the EU provides an easy scapegoat for populist attacks. Many mainstream politicians in our countries have also succumbed to the temptation. But it would be too easy to just blame populism without looking for the causes.

Citizens have been increasingly cut off from decisions that directly affect their everyday lives, decisions taken by institutions they do not identify with or feel able to influence in any way: European policies without European politics, in other words. Of course, the debate about globalisation, democracy and national sovereignty is not very different (Rodrik, 2011), but it is still on another scale to the debate relating to Europe and European integration.

4. For a more detailed proposal see Tsoukalis (2005), the reports by the Glienicker group and the Eiffel group: http://www.glienickergruppe.eu/english.html and http://www.bruegel.org/nc/blog/detail/article/1250-for-a-euro-community/ among others.

There has also been a growing disconnect between political elites and citizens in many of our societies in times when the private increasingly trumps the public. Trust in national politicians, as well as national institutions, has reached an all-time low in several countries, while the vacuum created by diminishing support for traditional parties has largely been filled by populists and demagogues. Interestingly enough, in southern Europe trust in European institutions is usually measured as being higher than trust in national institutions, while it is the other way round in northern Europe. This is another manifestation of the growing divide between north and south.

The big political failures of recent years have surely contributed to this disconnect between political elites and citizens, whether it is the bursting of the big bubble following many years of an ideologically loaded and basically naïve approach to how financial markets are supposed to work, or the way our governments have managed or mismanaged the crisis since then. Prolonged economic stagnation and high unemployment do not help, and neither does large-scale corruption in several countries. Hence the rise of anti-system parties or movements.

The political system is no longer seen to deliver the goods, or, at least, not enough of them. The extent to which this is due to policy failure or to tight constraints imposed on political power by a borderless economy that sets the pace and often dictates the rules is, however, a moot point. There is a difference between democratically-regulated markets and market-driven democracies. Arguably, we have veered too far towards the latter as a result of free capital movement and the liberalisation of financial markets, which are, in turn, products of the prevalent ideology.

Many young people are angry. They have inherited a heavy debt burden from their parents' generation, while their job prospects are poor in several parts of Europe, mostly the south. No surprise, then, that many prefer to vote with their feet while others begin to throw stones. It could get worse. There is, however, an even bigger category of losers in the long economic transformation we have been going through over the last two or three decades, which is linked to technological innovation and globalisation. This is a phenomenon witnessed in much of the developed world, not just in Europe.

Inequalities have been growing within our societies. Domestic social contracts have come under challenge. In those countries worst hit by the crisis, they are literally being torn apart. This is the age of uncertainty and precarious employment for an increasing number of people in the developed world, while others continue to enjoy the benefits of open borders and a shrinking world. Because of the crisis, the number of losers keeps rising.

What I want to stress here is that these underlying trends predate the crisis, but they have been accentuated by it. They are directly related to developments above or below the European level but they greatly affect Europe and European integration. The latter is now perceived by many people as being part of the problem and no longer part of the solution. Those who identify themselves as losers turn anti-establishment. In their eyes, the EU is part and parcel of the establishment they have come to resent.

The bursting of the biggest financial bubble since 1929 soon turned into the mother of all crises for the European currency union, and not only that. It now looks like an existential crisis for European integration, testing the limits of the joint management of interdependence when economic divergence grows and nationalism rises, while also testing the limits of solidarity when fragmentation becomes a key word and domestic social contracts undergo a major transformation.

We could go on. These are indeed interesting times, in the Chinese meaning of the word. Some of the fundamentals of the European success story developed during the second half of the twentieth century are now facing serious challenges.

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THE ECONOMIC AND MONETARY UNION AND ITS EVOLUTION SINCE THE CRISIS

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Introduction

The euro area has recently experienced the worst crisis since its inception. This crisis has had profound effects on both the economy of the single-currency area and on the rules and institutional relations that characterise the structure of the European Economic and Monetary Union (EMU). These developments are the subject of this article. First, an overview is given of the economic developments in the euro area since the start of the crisis and the underlying weaknesses in the EMU architecture that the crisis revealed. Second, the article discusses the policy response to the challenges that the crisis has brought to the fore. As will be shown, this policy response has been sizeable and has substantially contributed to mitigating the crisis' immediate negative effects and to reconstructing a more sustainable framework for the EMU. Looking forward, the article gives an overview of the challenges that remain and concludes by offering possible policy avenues to be pursued in the coming period in order to move towards a deep and genuine EMU.

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The crisis and the weaknesses in the EMU architecture

The eruption of the financial crisis in 2007/2008 had a substantial impact on the economies of the euro area member states (Van Duin and Amtenbrink, forthcoming). The bursting of the housing bubble in the US rapidly spread across the globe and led financial flows between banks and countries to dry up: directly, via its effects on company balance sheets, and indirectly because of the resulting decrease in confidence between financial market participants. The hit taken by the financial sector led to a significant decrease in funding to the real economy and investment. At the same time, the macroeconomic imbalances that resulted, for example, in the housing sector, and in the accumulation of private debt meant a swift process of unwinding began that revealed a massive misallocation of resources. Finally, the crisis caused a general drop in consumption and investment as a result of its effects on confidence. Altogether, this caused the euro area Gross Domestic Product (GDP) to drop by 4.4% in 2009.[1] Although the first signs of a recovery

1. See Eurostat http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115, last accessed 28 July 2014.

are slowly becoming apparent, the euro area has since experienced a double dip recession, and growth in the past years has remained subdued.

The crisis took its toll on all member states, affecting public finances, notably through the necessary use of automatic stabilisers, the creation of (coordinated) stimulus packages[2] and member state interventions to safeguard the functioning of the financial markets. The size of the initial blow and the subsequent developments, however, differed markedly from member state to member state, reflecting the different characteristics of their economies. The size of their financial sector, the openness of their economy, their initial fiscal positions and the existence of macroeconomic imbalances and the main factors behind them, particularly when related to private debt levels, all proved to be important explanatory variables. With markets suddenly awaking to the risks of potential government default, several of the harder hit euro area member states found it increasingly difficult to fund themselves in the markets. For some, these developments progressed to such an extent that they eventually turned to the EU for emergency funding assistance. In May 2010, Greece was the first of these, in part because of the discovery of the large-scale manipulation of statistics. The number of member states in need of assistance steadily increased to the point where a total of four—Greece, Ireland, Portugal and Cyprus—became dependent on emergency loans from other EU member states. In addition to these, Spain, although it did not lose market access, found itself in a position where it needed to request emergency assistance with the specific aim of supporting its financial sector.[3]

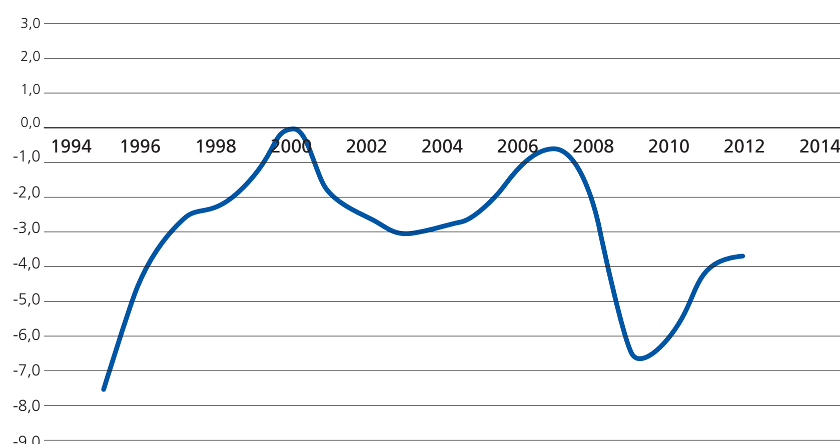
Developments in the euro area since the start of the crisis can be at least partially attributed to the original configuration of the Economic and Monetary Union in the 1990s as set out in the EU Maastricht Treaty. This setup had been based on a "no bail-out" rule for euro area member states, national decision-making on budgetary issues within the confines of the Stability and Growth Pact (SGP),[4] and a soft process of peer pressure and policy learning in the area of economic policies, notably in the context of the Lisbon Strategy.[5] Furthermore, financial regulation, supervision and resolution in the internal (financial) market was still largely organised at a national level. This proved insufficient to prevent the euro area economy from developing a number of characteristics that aggravated the impact of the crisis. The common currency had led to a convergence of interest rates among euro area member states to the extent that markets found them insufficiently differentiated on the basis of economic and budgetary principles. For member states on the periphery this generally meant a significantly lower real interest rate than before joining the euro area. This encouraged lending by both the public and private sector and a consequent rapid accumulation of debt. The financial sector itself also found it easier to lend money in the capital market which led to increased risk-taking aimed at increasing profitability. Altogether the flow of cheap credit to the economy financed growth while subduing the need to improve underlying economic fundamentals with the implementation of structural reforms.

In general, the structure of the EMU therefore provided insufficient incentives for member states to adapt to the requirements of sharing a common currency; the reasons such adaptations were necessary become

2. An example of such coordinated action was the European economic recovery plan adopted by the European Council in December 2008 on the basis of a Commission proposal. See European Commission, *A European Economic Recovery Plan*, COM (2008)0800.
3. By summer 2014, Spain, Ireland and Portugal have exited these emergency assistance programmes, returning to market funding.
4. Council Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ 1997 L 209/1; Council Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ 1997 L 209/6.
5. See European Council conclusions 23/24 March 2000.

apparent when the various elements are examined separately. First, the excessive accumulation of public debt and the associated emergence of risks to the sustainability of public finances had been made possible because the SGP was insufficiently supervised and turned out to be incomplete in terms of properly capturing all the elements of sustainable public finances.[6] Also, two essential building blocks of the system—namely, national fiscal frameworks and the independent collection of statistical data—proved, in some instances, not to be up to the task. The SGP was meant to ensure that countries pursued a stable and sustainable budgetary position, using the economic good times to create the fiscal space for more difficult ones. But this did not work as it should have, as is illustrated by the persistent overall euro area deficits in Figure 1. Moreover, the 60% debt to GDP ratio as a criterion for the maximum level of government debt was never operationalized. This combination left numerous member states with very little fiscal space at the onset of the crisis.

Figure 1. Euro area general government deficit (% of GDP)

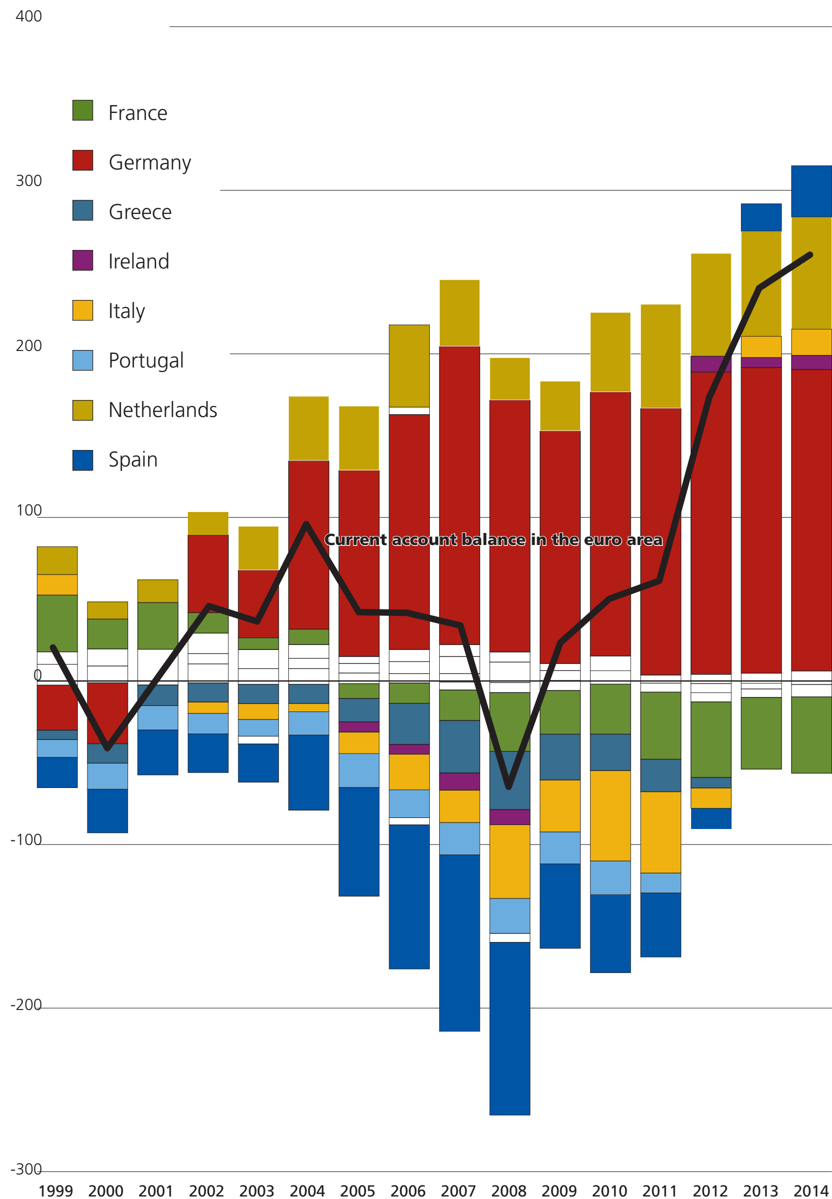


Data source: Eurostat

Second, within a monetary union a large burden is placed on real economic developments in order for member states to adjust to macroeconomic shocks and assure competitiveness. However, member states did not sufficiently implement the necessary structural reforms to improve the functioning and flexibility of labour and product markets. This led to a divergence in competitiveness between euro area member states, as illustrated by the increasing divergence between current account deficit and current account surplus economies in Figure 2. During the crisis this characteristic contributed to the vulnerability of current account deficit countries (member states reliant on external funding) since they often suffered from an abrupt halt to financing while being unable to rapidly reassign factors of production factors to more competitive sectors. This lack of implementation of essential structural reforms to improve economic fundamentals illustrated both the insufficiency of EU incentives and the lack of scope and focus of the economic governance system in place, which was focussed on fiscal measures with much less attention given to the rest of the economy, meaning that the build-up of macroeconomic imbalances were not detected and corrective policies were not put in place in time.

6. For instance, the SGP did not capture cyclical revenues properly.

Figure 2. Current account balance in the euro area (Eur bn)



Source: European Commission

Finally, the delineation along national lines of issues of regulation, supervision and resolution of the financial sector proved a bad fit with the reality that financial sector activities increasingly took place in a cross-border and pan-European fashion. This caused difficulties during the financial crisis. Where rapid contagion effects due to the high level of interconnectivity between national financial sectors necessitated a rapid, comprehensive and coordinated course of action, it proved to be possible only to a limited extent. For instance, capital standards for financial institutions proved to be too low and too differentiated; national supervision allowed ring-fencing and with it the fragmentation of assets across national borders; and the cooperation between national supervisory and resolution authorities that was necessary to resolve cross-border

financial institutions often proved highly complex. The crisis also revealed the extensive interconnections between national financial sectors and the governments of member states. On the one hand, governments were often forced to come to the rescue of financial institutions in order to maintain a functioning financial system. On the other, in some instances, national financial sectors turned out to have invested heavily in national government bonds, the evolution of which contributed to their own balance sheet positions. In several member states, this created a vicious cycle of financial sectors and governments both getting into difficulties.

Filling the gaps; the work done on EMU 2.0

With the evolution of the crisis from financial to economic to one of sovereign debt and with the weaknesses set out above becoming apparent, a massive exercise to revise the original EMU setup was begun. This entailed improving the functioning of the EMU instruments that were already in place by filling the gaps that had been exposed in the governance structures, taking concerted action in the area of budgetary consolidation and carrying out structural reforms in order to restore sound economic fundamentals. With contagion effects threatening the very existence of the euro area as a whole, this exercise was carried out with great urgency. On the one hand, this often meant action was taken under enormous time pressure, necessitating some degree of improvisation. On the other, this facilitated the implementation of necessary measures within a timeframe and to an extent that would have been thought impossible only a few years before. This becomes apparent when examining the various elements of the EU crisis response separately.

The need for additional crisis management instruments became urgent as early as 2009/2010 when the Greek government became unable to fund itself in the market. This was a new situation to the EMU, which had no pre-existing modus operandi to build on. Using the possibilities at hand to the best of its ability, the first Greek emergency package therefore circumvented the EU institutional context altogether and relied on ad hoc bilateral loans from other member states. These loans were to be provided on the condition that the Greek authorities take a number of actions in the area of budgetary and economic structural reforms to facilitate the restoration of sound fundamentals and thereby an eventual Greek return to the markets. These reforms were set out in a Memorandum of Understanding (MoU), the monitoring and surveillance of which was placed in the hands of what became known as the "troika", the European Commission, the ECB and the IMF.

But this ad hoc solution only generated confidence in the stability of the EMU to a limited extent and underlined the urgent need for a more predictable and transparent system for such emergency funding exercises. Responding to these developments, the European Financial Stability Facility (EFSF) was created in May 2010 as a private company (*society anonyme*) under Luxembourg law, in parallel with the European Financial Stability Mechanism (EFSM) which was set up under article 122 TFEU. Together they were used for the emergency loan packages for Ireland, Portugal and for a second package for Greece.[7] Taking further steps towards a more stable and transparent system, the EFSF, which was established with an expiry date in 2013, was superseded by the European

7. See Council Regulation 407/2010 establishing a European Financial Stabilisation Mechanism, OJ 2010, L118; EFSF framework agreement and the Treaty establishing the European Stability Mechanism.

Stability Mechanism (ESM), a permanent emergency assistance structure that entered into force in September 2012. The ESM was used in the last emergency loan packages for Spain and Cyprus.[8] All three mechanisms relied on the same setup for monitoring and surveillance as the original Greek programme. The consistency of this system with the existing EU rules on multilateral surveillance was subsequently guaranteed by one of the two regulations comprising the so called "two pack" that entered into force in May 2013 and established the common rules for the setting up, surveillance and supervision of assistance programmes.[9] Finally, the European Central Bank (ECB), acting independently within the terms of its mandate as laid down in the EU Treaties, added to these EU-level crisis management actions in a number of different manners. Notable examples here are the Securities Market Programme (SMP) set up in May 2010, which allowed the ECB to intervene by buying the securities that it normally accepts as collateral on the secondary market, and its successor, the Outright Monetary Transactions programme (OMT), announced in August 2012, which allows for conditional purchases in the secondary markets of government bonds, especially those with maturities of between one and three years.

Alongside these crisis management measures, the EU system of economic governance was completely overhauled. First of all, beginning in 2011, the various components of economic and budgetary surveillance were fully integrated under the European Semester of economic policy coordination to ensure consistency of policies across policy areas. Also, the various components of economic governance were significantly strengthened. On September 29th 2010, the European Commission published the so called "six-pack" of legislative proposals to mitigate some of the additional weaknesses in the EMU. The "six-pack" included three regulations aimed at strengthening the Stability and Growth Pact, specifically targeting the weaknesses identified in the previous section. The credibility of the sanction mechanism was improved by the institution of additional possibilities in the form of (non-) interest- bearing deposits that also kick in earlier in the process. Room for political manoeuvring by member states was narrowed through increased automaticity in the SGP's application in the form of the so-called "reverse qualified majority voting" (reverse QMV) in the European Council. And the debt criterion was operationalized by the introduction of quantifiable rules for debt reduction, generally obliging member states with debt levels above 60% to decrease these excess levels by 5% each year. The "six pack" also included a directive on minimum requirements for national budgetary frameworks in order to strengthen their ability to ensure sustainable public finances at a national level, including rules on, for example, accounting and statistics, macroeconomic forecasting and medium-term budgetary frameworks. The package entered into force on December 13th December 2011.[10] National budgetary frameworks were further strengthened with the adoption of the Treaty on Stability, Coordination and Governance (TSCG), an intergovernmental treaty signed on March 2nd 2012 by 25 member states (at that time all but the UK and the Czech Republic) that entered into force on January 1st 2013. The TSCG put further obligations on signatory member states to strengthen national budgetary frameworks, notably by the obligatory introduction of a balanced budget rule in national legislation, and added additional elements for the enforcement of the SGP.[11] Finally, the second "two pack" regulation that entered into force on May 30th

8. T/ESM/2012/en. European Commission-DG ECFIN, 2012 y 2013a.

9. Regulation 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.

10. Council Regulation (EU) no 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, Regulation (EU) no 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Regulation (EU) no 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area and Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

11. Treaty on Stability, Coordination and Governance, http://www.consilium.europa.eu/media/1478399/07-tscg.en12.pdf, last accessed 31 July 2014.

12. Regulation (EU) no 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

13. Regulation 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances , OJ 2011, L 306/25; Regulation 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, OJ 2011, L 306/8.

2013 subsequently integrated some elements of the TSCG into the EU legal framework, notably the requirement for euro area member states to, ex ante, submit draft budgetary plans for discussion at an EU level each autumn.[12]

The remaining two regulations that made up the 'six pack' aimed to mitigate the weakness of the insufficient implementation of reform measures in order to prevent the emergence of harmful macroeconomic imbalances. These regulations, which also entered into force in December 2011,[13] introduced a formal EU monitoring and surveillance procedure for macroeconomic imbalances. Core elements of the procedure are: an alert mechanism report with broad indicators, in-depth studies and related country-specific recommendations for policy action, and the possibility of placing member states in an excessive imbalance procedure in the case of the existence of severe imbalances, including imbalances that jeopardise or could jeopardise the proper functioning of the Economic and Monetary Union. Once subject to an excessive imbalance procedure, euro area member states must submit to a corrective action plan containing concrete, time-restricted economic reforms. If this plan is deemed insufficient or is not implemented, the procedure can lead to the imposition of financial sanctions in the form of (non-interest bearing) deposits and fines.

The mitigation of weaknesses related to the organisation of financial regulation, supervision and resolution was also ambitiously pursued. Firstly, the European Financial Supervision system was overhauled to improve the early identification of financial stability risks, with the introduction of three new European authorities for the supervision of financial activities: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).[14] In addition, the European Systemic Risk Board (ESRB) was set up to perform EU-level macro-prudential oversight of the financial system.[15] Financial regulation was strengthened and harmonised with the development of the "Single Rulebook", with common rules, inter alia, in the area of bank capital requirements, deposit guarantee schemes and recovery and resolution tools for banks in crisis.[16] Finally, on September 12th 2012 , the commission adopted legislative proposals on a Single Supervisory Mechanism (SSM) for banks. The SSM was agreed in October 2013[17] and designates the European Central Bank (ECB) as the central supervisor of financial institutions in the euro area and in non-euro EU countries that choose to join the SSM. Before the SSM becomes operational in November 2014, banks will undergo an asset quality review and a stress test to identify any remaining vulnerabilities. A commission proposal for setting up such a Single Resolution Mechanism (SRM) was published in July 2013[18] and agreed between the council and the European Parliament (EP) in April 2014,[19] with the Single Resolution Fund being established in an accompanying intergovernmental treaty. The SRM will apply to banks covered by the SSM. If these banks fail, the mechanism will allow effective bank resolution through a Single Resolution Board and a Single Resolution Fund, financed by the banking sector, therewith contributing to breaking the vicious cycle between banks and sovereign debt. The SRM is predicted to enter into force on January 1st 2015, whereas the transfers of the banks' contribution to the Single Resolution Fund will start from January 1st 2016.

14. Regulation 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/78/EC, OJ 2010, L 331; Regulation 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, OJ 2010, L 331; Regulation 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ 2010, L 331.

15. Regulation 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJ 2010, L 331.

16. See http://europa.eu/rapid/press-release_MEMO-14-57_en.htm#footnote-1 for an overview of legislation agreed and proposed in this area, last accessed 31 July 2014.

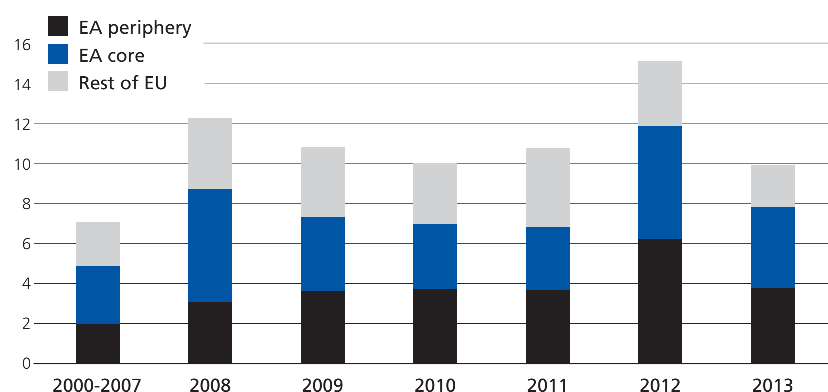
17. See Council Regulation 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and Regulation 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

18. Commission proposal for a regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation 1093/2010 of the European Parliament and of the Council, COM(2013) 520 final.

19. For the agreed text see http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2014-0341.

These actions to improve the institutional governance aspects of the EMU have been supplemented by impressive action to restore economic fundamentals, including hitherto unheard of budgetary consolidation and structural reform measures taken by the member states. Following substantial fiscal consolidation measures in most member states, the euro area as a whole has moved from a general government deficit of 6.4% in 2009 to a deficit of 3% in 2013, which is expected to further decline to 2.5% in 2014 (European Commission-DG ECFIN, 2014). General government debt in the euro area, which has been rising steadily since the onset of the crisis, is expected to peak in 2014 at 96% and decrease from then on. These developments are reflected in the application of the Stability and Growth Pact, where the number of euro area member states in an excessive deficit procedure halved from 16 in 2010 to 8 in 2014. In the area of structural reforms, significant action has been undertaken on the crisis across the euro area. Notably, progress in the area of labour market reforms has been impressive, as can be seen in Figure 3, with particular uptake of reform efforts in the more vulnerable member states. This implementation of reforms has in turn contributed to progressive improvements in competitiveness in these vulnerable member states and the strengthening of current account balances. Significant adjustment has taken place in the countries on the periphery of the euro area, which experienced high current account deficits prior to the start of the financial crisis. These vulnerable countries as a group actually recorded a surplus of around 1.3% of their GDP in 2013, a figure that is expected to further increase to 2.0% in 2015. A large share of this adjustment is non-cyclical and as such is not expected to dissipate once the overall economic situation improves (see Figure 2).

Figure 3. Labour market reforms (average number of adopted reforms per year)



EA periphery: EL, IT, IE, PT, ES; EA core: AT, BE, FI, FR, DE, NL, SK; Rest of EU: CZ, DK, UK, SE, HU
Source: European Commission, 2014.

In addition, even before the results of the ECB's asset quality reviews and stress tests the financial sector has been taking steps towards more sustainable balance sheet positions, increased solvency and liquidity. Notably, the capital position of banks in the euro area as measured by the core tier 1 ratio improved by 2.4 percentage points between 2011 and 2013, due to decreases in total assets, changes in average risk weights and increases in capital.[20]

20. Data source; European Central Bank, *SNL financial*, 2014.

The euro area's evolving challenges

In restoring the sustainability of the Economic and Monetary Union, the combined action in the various areas as set out in the previous section is starting to bear fruit. The European Commission currently predicts euro area GDP growth of 1.2% and 1.7% in 2014 and 2015, respectively (European Commission-DG ECFIN, 2014). However, recent figures have shown that the euro area's economic recovery, which started in the second quarter of 2013, is not materialising as expected, with growth losing momentum, particularly in the three largest EU member states. The recovery remains fragile and the nature of the challenges the euro area faces is changing. The main challenges no longer concern the need to establish budgetary credibility in the face of rampant deficits and swiftly increasing public debt, the need to stop negative feedback loops between sovereign debts and the banking sector or the need to fix problems of the real economy characterised by unsustainable current-account deficits and worrying losses in competitiveness, increasing private debts and high housing prices. Instead, the euro area currently faces challenges of a different kind, which, although less of a crisis nature, are just as daunting.[21]

Firstly, the process of rebalancing the euro area economy is far from complete while the debt legacy that resulted from the crisis remains. At 96% of GDP, the level of public debt in the euro area remains well above the original 60% threshold set out in the SGP. Moreover, in many euro area countries there is still a long road ahead in terms of completing the process of deleveraging in the consumer and business sectors, which is holding back consumption and investment (see Figure 4). More specifically, *external* debt balances are still very high in most vulnerable member states. To further reduce the levels of external indebtedness, the improved current account balances in these member states need to be sustained in the future. The rebalancing process in the euro area has been asymmetrical, with limited progress in member states with a current account surplus. This led the euro area current account balance to move to a surplus of around 2.2% in 2013 which is forecasted to remain at roughly this level in 2014 and 2015 (see Figure 2). This development poses two risks. First of all, the lack of adjustment to current account surpluses reflects weaknesses in domestic demand in current account surplus countries, which could, in turn, hamper EU growth potential. Additionally, the growing current account surplus could contribute to the appreciation of the euro, which might make it more difficult for vulnerable countries to make progress in regaining competitiveness.

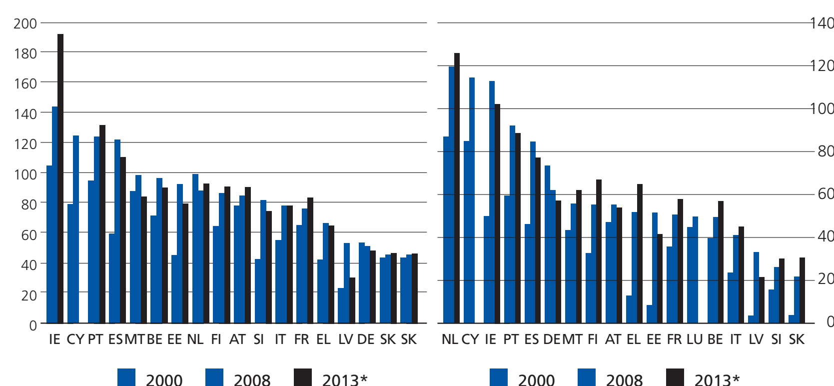
The second main challenge that the euro area faces today relates to the unemployment and social problems that have risen to unacceptably high levels due to the crisis. Unemployment reached 12% in 2013, with strong increases in a third of euro area member states, including a number of countries where rates were already very high. Long-term unemployment has also continued to rise, reaching 50% of total unemployment in 2013. The risks of unemployment becoming increasingly structural and less responsive to wage dynamics have grown. Related to this, the social situation in the euro area deteriorated throughout the crisis, with almost all social indicators, such as the at-risk-of-poverty rate and the material deprivation rate, worsening in 2012.[22] This is bad news from an economic perspective, since it can have negative effects

21. See already European Commission "Assessment of the 2014 national reform programmes and stability programmes for the euro area", SWD(2014)401 final (on-line): http://ec.europa.eu/europe2020/pdf/csr2014/swd2014_euroarea_en.pdf.

22. See Eurostat http://epp.eurostat.ec.europa.eu/ last accessed 31 July 2014.

on both long-term growth and public debt sustainability. Poverty influences productivity, via access to education, for example, while inequality has dynamic effects on growth through its effects on private debt accumulation and consumption growth. Another non-negligible effect is that increases in poverty and unemployment can contribute to 'reform fatigue' at a time when continued reform efforts remain very much necessary.

Figure 3. Private sector indebtedness, NFCs (left) and Households (right), (% of GDP)



Note: consolidated figures presented for NFCs. Debt includes loans and securities other than shares, excluding financial derivatives. LU excluded in the figure on NFC indebtedness.
Source: Eurostat.

Thirdly, financial fragmentation and a related heterogeneity in lending conditions remain high, and access to finance, especially for SMEs, remains challenging in many member states. This is due to elements on both the demand and supply sides. On the supply side, weak economic growth combined with inherited balance sheet issues and continued corrections in residential and commercial property markets results in worsening credit quality and increases in the Non-Performing Loan (NPL) ratios of banks. These NPLs tie up capital and funding, negatively influencing banks' capacity to extend new loans to productive firms. The same elements negatively affect borrowers' debt-servicing capacity and dampen overall credit demand. This relates to the persistence of an investment gap within the euro area. After a sharp decline since 2008, investment is now picking up, but slowly, and it is set to remain below its long-term average in most euro area member states until 2015, with the shortfall particularly large in the more peripheral countries. The risk of a funding gap for productive investment which could undermine the economic recovery remains acute.

Moving forward: towards a strong, sustainable EMU

Europe's Economic and Monetary Union has undergone fundamental changes in recent years. The crisis has hit hard, and exposed weaknesses in the member states' foundations and the EMU's institutional setup that had been partially hidden in previous years. While the initial economic shock was large, the EU's policy response has been equally fundamental. The steps taken in fixing the EMU's design flaws have been profound, even more so given the short time span in which they

have been carried out. They go much further than was thought possible some years ago and have been implemented in conjunction with impressive and ambitious measures taken at both EU and national levels in the areas of budgetary, economic and financial policies in order to restore the underlying principles. As set out in the previous section, however, important challenges remain and the pursuit of ambitious policy action remains necessary. The evolving challenges in the euro area in this regard call for both a continuation and a reorientation of policy priorities along a number of different lines.

First and foremost, moving the Economic and Monetary Union from fragile recovery to strong and sustainable growth and jobs creation calls for continued ambitious implementation of structural reforms in product and labour markets. The benefits of such structural reforms are multifaceted and can be linked to the resolution of most if not all of the challenges set out in the previous section, while they can also contribute to the euro area's ability to take on already existing long-term challenges related to the ageing of the EU population and globalisation, among others. Structural reforms have the potential to contribute to a durable rebalancing process and lessen the negative impact of private sector deleveraging. They can also facilitate smoother real wage and productivity adjustment, which in turn leads to a smoother reaction in employment and, consequently, in real output. And through their effects on growth, productivity and employment they contribute to improving the sustainability of private and public debt as well as the overall social situation.

The evolving challenges in the euro area in this regard call for some reorientation of priorities. As stated before, the implementation of reforms in labour markets in recent years has generally been impressive. However, there is still much room for improvement. For instance, with an average tax wedge of over 45%, the composition of taxes in the euro area remains heavily geared towards taxation on labour, significantly more than other advanced economies like the US and Japan who have tax wedges at around 31%.[23] Also, less progress has been made in the implementation of reforms to improve the functioning of product and services markets, notably in the euro area's core economies. Given the fact that a stepping-up of the implementation of reforms in these areas would also facilitate an increase in domestic demand, including investment, a reduction in current account surpluses and a more symmetrical rebalancing process, increased focus on these areas is warranted.

The system of economic governance as it exists in the EMU today gives important tools to facilitate the implementation of these structural reforms by member states. Notably, the European Semester and the Macroeconomic Imbalances Procedure can and are being used to target such priority areas and influence member states' decision-making processes to facilitate implementation. Furthermore, the Eurogroup, the informal meeting of the euro area finance ministers, has begun to hold themed discussions on exactly these areas with the aim of inducing peer pressure and mutual learning among member states while looking further into possible spill-overs related to the (non)implementation of such reforms.[24] At the same time, under the current system there is arguably still room for improvement, particularly in the area of solidifying the commitment to reform in the member states. In this regard, discussions are ongoing on the possible added value of a system of contractual

23. OECD (2010), "Taxing Wages: Comparative tables", OECD Tax Statistics (database).

24. See e.g. Eurogroup statement on reducing the tax wedge on labour., http://eurozone.europa.eu/newsroom/news/2014/07/eurogroup-statement-on-reducing-tax-wedge-on-labour/ last accessed 31 July 2014.

arrangements at two levels: EU and member state.[25] In these contractual arrangements, member states would commit themselves to the implementation of the key reforms necessary to ensure a well-functioning EMU. And to assist member states in overcoming possible short-term costs related to the implementation of these reforms, such contractual arrangements could be accompanied by a system of solidarity funding at EU level. In general, any such considerations on improving the EU economic governance system can be expected to feature in the review exercise that the European Commission will conduct in accordance with the legal obligations set out in the various pieces of legislation on December 14th 2014.

The second main avenue for further action relates to budgetary consolidation. Given the enormous progress made in the past years, budgetary consolidation can indeed now progress at a slower pace than before. But fiscal policy needs to continue to ensure debt reduction. A main challenge here is preventing the emergence of consolidation fatigue related to a general sense of complacency. The renewed SGP has all the tools necessary to facilitate such continued adjustment, and the continued, consistent application of these instruments will be key. At the same time, the focus of attention in terms of fiscal policy in the euro area should move progressively take place towards the issues of the quality of public finances and the appropriateness of the overall euro area fiscal stance. Concerning the quality of public finances, a more growth-friendly mix of spending and revenues and increased efficiency of spending is essential. Given the current challenges in the euro area, this includes the stepping-up of material and immaterial productive investment, for example, in the areas of infrastructure and innovation, an area that has, in the context of the crisis, often unfortunately been seen as an easy target for consolidation. This is illustrated by the fact that the average expenditure on capital formation stood at 4.3% of total spending in 2013, down from 5.7% in 2007.[26] Furthermore, given the potentially large spill-overs between euro area member states, they have a collective responsibility to ensure an appropriate overall euro area policy stance, notably from the point of view of ensuring appropriate aggregate demand. Again, effective use of the European Semester is pivotal to achieve these objectives. Beyond this, discussion in the Eurogroup could contribute to a better understanding of the situation and the implications of spill-overs in the euro area, both within the context of fiscal policy and between the various policy areas. First steps in this regard were taken in 2013 in the context of the discussion of the draft budgetary plans submitted by the euro area member states under the new rules of the 'two pack',[27] which provide the basis for further elaboration of this in the coming period.

Thirdly, the financial sector continues to be in need of undivided focussed policy action to restore the necessary funding to the economy. Continuity in the policies is necessary in the finalisation and implementation of all banking union initiatives, including further repairing bank balance sheets and continuing to strengthen equity buffers in the context of the ongoing asset quality reviews and stress tests. If fully and properly implemented, the banking union will create a more robust financial sector in the euro area, making all banks safer, in the first place by crisis prevention, while supervision and resolution under the SSM and SRM will, where necessary, take place in a more coherent, efficient

25. See e.g. European Commission, *Towards a Deep and Genuine Economic and Monetary Union; The introduction of a Convergence and Competitiveness Instrument*, COM(2013)165.

26. Data source; commission services AMECO databasehttp://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm last accessed 31 July 2014.

27. See eurogroup statement on the review of national budgetshttp://www.eurozone.europa.eu/newsroom/news/2013/11/eurogroup-statement/, last accessed 31 July 2014.

and transparent manner with less risk to national taxpayers. Alongside its direct effects on the provision of funding this will also benefit the general level of confidence within and towards the banking sector, giving an additional boost to economic development. Reorientation, on the other hand, is needed in taking steps towards the diversification of sources of finance. European capital markets remain underdeveloped and may play an insufficient role in filling the funding gap created by bank deleveraging. In this sense, a number of bottlenecks exist that need to be overcome in order for capital-market financing to take off. In March 2014, the European Commission adopted a Communication on long-term financing with a concrete action plan to address this issue, including the revitalisation of the securities market.[28] This should form the basis of new tasks to be undertaken.

Finally, work should be continued with the aim of fully eradicating policy uncertainty related to the future of the EMU and the further steps needed to ensure the sustainability of the EMU setup for the future. As was made abundantly clear at the height of the crisis, the effects of uncertainty are very real and high levels of economic and policy uncertainty impede investment decisions.[29] It can significantly and negatively weigh on private spending and economic growth, as well as giving agents an incentive to postpone investment, consumption and employment decisions. Great uncertainty becomes all the more damaging for growth as it magnifies the effect of credit constraints and weak balance sheets, forcing banks to reign credit in further and companies to withhold investment, even if they are not liquidity-constrained, in order to minimise the risks of irreversible decisions.[30]

Arguably, with the actions undertaken over the past years by EU member states and institutions, the tail risks of the euro ceasing to exist altogether have dissipated. The consistent implementation of the actions set out in the previous paragraphs in the areas of structural reforms, fiscal policy and the financial market will, alone, contribute to further reduction of uncertainty. However, the necessary additional steps to be taken to fully ensure the EMU's sustainability, or, in other words, what actually constitutes a *deep and genuine* EMU remains a topic for discussion. Deliberations on this subject have been ongoing at the highest political level ever since the publication by the Commission of the Blueprint for a deep and genuine EMU in November 2012.[31] The Blueprint provided an overview of the measures to be taken to strengthen the EMU in response to the crisis, as well as a comprehensive vision for a deep and genuine EMU built on a strong and stable architecture in the financial, fiscal, economic and political domains. The commission set out a step by step approach, with concrete actions to be taken in the short, medium and long term, combining substantial ambition with appropriate sequencing, including, in the long term, possible changes to EU treaties. Discussion on these issues in the context of the European Council have, up to now, been less than conclusive, revealing fundamental differences of opinion between the various member states. The debate is expected to regain momentum in the context of the new European Commission and European Parliament beginning their terms.[32] Discussions are expected to follow the commission's Blueprint for a deep and genuine EMU, and include some of the issues already mentioned in previous paragraphs, such as further improving the euro area's economic governance mechanisms to improve ownership and the commitment of member states to implementing key

28. European Commission, *Communication on long term financing of the European economy,* COM(2014)168.

29. European Commission analysis of the euro area has shown that uncertainty has had a significant effect both on investment and consumption, see European Commission-DG ECFIN, 2013b).

30. See also Marco Buti and Philipp Mohl *"Lacklustre investment in the Eurozone: Is there a puzzle?",* at http://www.voxeu.org/article/raising-investment-eurozone, last accessed 31 July 2014.

31. European Commission, *Blueprint for a deep and genuine EMU; launching a European debate,* COM(2012)777.

32. See for instance the new political priorities as set out by Jean Claude Juncker, the next Commission President, where the creation of a deeper and fairer economic and monetary union is one of his key focal points., at http://ec.europa.eu/about/juncker-commission/docs/pg_en.pdf, last accessed 31 July 2014.

structural reforms. It could also include the taking of further steps in the area of banking union such as the creation of a common public backstop for the SRM, the creation of united external economic representation for the euro area and further pooling of resources at a euro area level by creating targeted fiscal capacity. All of these issues can provide additional benefits as far as the robustness of the EMU setup is concerned. In particular, the last of these, depending on the exact specifications of the proposal, could form a valuable contribution to EMU stability, both by helping member states overcome the short-term costs of reforms and by assisting member states in mitigating asymmetric macroeconomic shocks, for instance, in the form of a common EU unemployment benefit scheme.[33] The main challenge in overcoming policy uncertainty in this area, however, remains that of securing the necessary consensus on the desired way forward for the EMU. This means finding a way to overcome the inherent differences in perspective of the various actors and securing a broad-base of political and societal support for the path to be undertaken, including ensuring that the necessary democratic legitimacy and accountability mechanisms are in place. The challenge is formidable, but the reward can be equally great. Combining this clear vision with the ambitious implementation of reforms in labour and product markets, pursuing a growth-friendly differentiated fiscal policy and mobilising the financial sector towards freeing up credit to the real economy along the lines set out above will allow the Economic and Monetary Union to reach its full potential as an engine for sustainable growth and job creation in Europe.

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33. For some first explorations on how such mechanisms for macroeconomic stabilisation in the form of an euro area unemployment benefit scheme could look see Strauss, R. Paper on Automatic Stabilisers, at http://ec.europa.eu/social/BlobServlet?docId=10964&langId=en, last accessed 31 July 2014.

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Introduction

The euro was launched in 1999 with the intention of making the economies of Europe more stable, more integrated and more prosperous. It was also a big step forward in the process of creating "ever closer union", by which a more united European Union would allow its citizens to more effectively pursue the goals of security, liberty and prosperity in an increasingly competitive and globalised world.

This paper is based on the proposals made in Steinberg, Federico; Stephen Pickford y Miguel Otero-Iglesias (2014): How to fix the euro. Chatham House, Real Instituto Elcano and AREL. I would like to thank Alba Benito Miranda for her support in preparing this paper

However, after an initial decade of success, in which the euro area experienced relatively strong economic growth that masked some major problems in its design, the global financial crisis that began in 2007 and turned into a debt crisis on the European periphery in late 2009 put the euro on the verge of collapse.

It was only in 2012 – once the president of the European Central Bank (ECB) Mario Draghi promised to do whatever it took to save the euro – that markets calmed down. Draghi's compromise, however, followed a number of political decisions to strengthen the governance of the euro, including renovation of the fiscal rules, the creation of a European bailout fund (the European Stability Mechanism, (ESM)) and the first steps towards a banking union. But three years after that market panic, some of the major underlying issues still remain. Leaving aside the fact that the European response to the crisis was slow, included some major policy mistakes and reflected important divisions between creditor and debtor countries that still persist today, the architecture of the euro still needs completion to ensure that the Economic and Monetary Union (EMU) can function effectively in the future. Moreover, the eurozone faces new economic and political challenges that require renewed political leadership. Unsustainably high levels of unemployment in the southern countries, increasing risks of deflation, growing debt levels and the rise of anti-European feeling will all have to be confronted.

This paper focuses on what remains to be done in order to build a sustainable eurozone in the long run. For this reason, it does not concentrate on current economic policy debates. It argues that greater

integration across all aspects of economic policy (fiscal, banking and economic) is needed, as well as political and institutional reforms to provide democratic legitimacy for more integrated and coordinated policymaking within the euro area.

The road ahead

Since the beginning of the crisis in 2008, large steps have been taken to improve the governance of the eurozone and make the euro sustainable. However, more needs to be done to ensure that the EMU is not vulnerable to further crises. Since the EMU is not an optimal currency area, it has to be underpinned by adequate political institutions and governance structures capable of responding in times of crisis. Its original design was sufficient for good economic times, but was clearly not well-suited to the challenges posed by a deep crisis.

The necessary reforms for an effective EMU include steps towards fiscal union (including measures to ensure national fiscal sustainability and adequately-funded fiscal transfers), macroprudential and banking policies to ensure sustainable financial integration (with a common supervisor and a common mechanism to resolve failing financial institutions, as well as a common deposit insurance scheme), and an economic union to facilitate convergence of competitiveness across the euro area. These reforms are deeply interconnected and need to be closely integrated. This requires a legitimatised governance structure that also allows the relevant policymaking bodies – both national and European – to coordinate their actions.

Fiscal issues

The euro area must work harder to create an all-inclusive fiscal union, since deeper fiscal integration is necessary to prevent the otherwise continual outbreak of tensions within the EMU. The market pressures that arose in many European countries during the economic crisis have stressed the need for credible and sustainable fiscal policies across Europe. However, these policies also need to be flexible in order to react to country-specific shocks and to more equitably distribute the burden of adjustment for competitiveness gaps between "surplus" and "deficit" countries. Moreover, deeper coordination is needed for aggregate fiscal policy settings to be established properly in the euro area. Finally, fiscal and monetary authorities will need to enter into an articulated political dialogue.

To date, progress has been made in the creation of structures capable of exerting national fiscal discipline and of improving policy coordination in the euro area. Nevertheless, the advance towards deeper fiscal integration which would enable transfers to counterbalance country-specific shocks or inappropriate monetary policy settings has been quite limited. In the absence of other measures, even if fiscal rules are enforced, they will not be able to respond on their own to the future problems that result from asymmetric shocks. Therefore, the euro area needs new central fiscal capacity that enables the transfer of funds to certain regions in order to set fiscal policy and to finance structural policies that foster

growth and competitiveness at eurozone level. However, these transfers will only be possible if they are made in accordance with transparent laws (that euro area citizens find legitimate) and under a central fiscal authority.[1]

Thus, the euro area will need a single central treasury function with the power to influence national budgets, monitor national accounts, determine fiscal transfers, issue debt and directly or indirectly collect eurozone-wide taxes. In fact, although national governments will still be able to decide on the balance between tax and spending and on the balance between specific forms of revenue and expenditure, the central fiscal authority will determine the overall fiscal position of the euro area and member states will share the responsibility for centrally-issued debt. In order to work, this supranational authority would need to be democratically legitimate and accountable at both national and European levels. It could be headed by an economics and finance minister from the euro area, the president of the Eurogroup or even the vice-president of the European Commission.

There are three potential ways of financing the fiscal capacity. The first is through the collection of new eurozone taxes, such as environmental taxes and a financial transactions tax. The second is through the receipt of resources sent directly by member states. In order to regulate these contributions, a system should be created to prevent one country always being a net contributor or a net recipient of the fiscal capacity (i.e. to avoid constant transfers from northern to southern countries, which would inevitably lead to political refusal in the creditor states); the third way is through the issuing of common debt instruments such as short-term eurobills or long-term euro bonds, which would constitute joint liabilities for all member states. The issue of these securities (which would be made by a new euro area debt agency) would implicitly involve subsidies being given by countries with high credit ratings to countries with lower ones. Moreover, these securities would contribute to improving debt sustainability in all eurozone states (as they would constantly decrease debtor countries' financing costs),[2] and to a deepening and widening of eurozone financial markets. The latter could result in an expansion of the international role of the euro, a reduction of overall euro area financing costs, and an increase in Europe's international monetary influence (Steinberg and Otero-Iglesias, 2013). Finally, given critics' worries about the moral hazard that comes with common debt, effective incentives for policy reforms (both structural reforms and fiscal discipline) would need to be implemented in weaker countries.[3]

In order to determine fiscal capacity for spending on resources, a technical assessment capability, for which the Macroeconomic Imbalances Procedure (MIP) could provide an analytical framework, would be required. The funds could be spent in several areas that promote the euro area economies' convergence and competitiveness, on policies that counteract negative asymmetric shocks and prevent negative spillovers or on EU-wide investment projects such as energy and physical infrastructure, pan-European industrial and R&D policies, and on a euro area unemployment insurance fund (capable of protecting cyclically unemployed workers in states that have implemented labour market reforms in accordance with the guidelines provided by the Commission). Given

1. For a discussion see Sapir (2011).
2. For a study on how a euro bond would reduce the financing costs of euro area member states, see European Primary Dealers Association (2008).
3. The Blue Bond or the Redemption Fund proposals could be a potential a solution because member states would remain individually responsible for debts over 60% and thus market discipline would be maintained. See Delpla and Weizsäcker (2010) and Bofinger (2011).

that the already-working ESM provides temporary loans to countries suffering from financial and banking problems and that it issues "small" amounts of common debt, the fiscal capacity would complement this mechanism. The following section will argue that the banking union's common resolution and deposit insurance mechanism should eventually have access to a common fiscal backstop which should be greater than the one presently considered. However, in the end, a legitimate political structure is necessary since decisions on the allocation of spending across the euro area are highly political.

Banking union, macroprudential policy and the role of the ECB

The project of creating a banking union is already underway.[4] In fact, a single rulebook has been implemented and is now operating in the EU, and the SSM is currently supervising the largest 130 banks in the euro area. Nevertheless, the SSM will progressively expand its sphere of influence beyond the largest banks, which means that human resources will need to be transferred from national supervisors to the ECB. Even though this process will take time, serious problems are not envisaged.

Nevertheless, more important problems have emerged with the Single Resolution Mechanism (SRM) and the insurance deposit scheme, the other two pillars of the banking union. For instance, the SRM needs to include a sufficiently large and credible common fiscal backstop. In fact, by 2026 its fund is expected to reach €55 billion, a sum that will be increased gradually by taxing banks. These private resources, as well as the resources provided by the new bail-in rules and complemented by the ESM (up to €60 billion), would act as a cushion in the event of bank failures. Nonetheless, these resources will be partially divided into national compartments (with national authorities being partly responsible for the recapitalisation of their banks) until 2026 (the end of the transition period) when these resources will be completely merged. However, these could cause problems, since bank failures could once more put the solvency of states at risk, especially in a deflationary environment. Another concern is the total amount of resources available. In fact, if the euro area is stricken by a systemic banking crisis that affects various financial institutions at the same time, the amount of resources will undoubtedly be insufficient, given the size and scale of the euro area banking sector. In such a case, either the ESM would have to be expanded or the SRM would need to be given access to the aforementioned fiscal capacity (part of the fiscal union).

Lastly, there has been no breakthrough in the creation of a common insurance deposit scheme. For instance, deposits of up to €100,000 in all the euro area banks should almost certainly be secured if a level playing field between banks from different countries is to be ensured. Similar to the case of the SRM, if the SSM decides that a bank can no longer meet its liabilities, deposits will be guaranteed by a fiscal backstop, eventually linked to the fiscal capacity and connected to the SSM. In the end, the banking union should aim to increase competition in the banking industry across the euro area and to reduce "home bias" so as to allow some pan-European banks with retail operations in all euro area states to emerge.

4. For a detailed discussion of its main elements see Nicolas Veron (2014) "Banking Union in nine questions". Petersen Institute for International Economics (http://www.bruegel.org/fileadmin/bruegel_files/Publications/Testimonies/InterparliamentaryConf_Sep2014.pdf) and Howarth and Quaglia (2013).

Macroprudential policies will become more important in the banking union as their role in reducing financial risks across the eurozone, and in adapting to country-specific circumstances, grows. An example of these policies can be found in Spain, where they were implemented before the crisis to contain the expansionary effect of easy monetary conditions. However, the development of these policies is still in its infancy. In fact, the creation of the three European regulatory agencies and of the European Systemic Risk Board (ESRB), which is closely related to the ECB, reflects the fact that the governance structures are better developed than the policy instruments. Nevertheless, close coordination between the European institutions responsible for macroprudential policies will be required in order for these to work. Regarding the role of the ESRB, it will have a major task in fighting financial risks across the entire single financial market through the establishment of guidelines for action that will then be implemented mainly by the SSM. Moreover, these macroprudential policies will require strong coordination with the single monetary policy, which will only be reached if the ECB fully takes on this role for the euro area or if a subset of the ESRB composed only of euro area members is constituted. This body would then set precise and nationally-binding macroprudential policy actions that take into account the unique circumstances of each country. Furthermore, given the macroeconomic consequences of these actions and their possible fiscal impacts (e.g. tax receipts), the euro area macroprudential body will need to collaborate with the central fiscal authority.

In addition, the ECB, one of the most powerful institutions in Europe since the outbreak of the crisis, will seize more powers. In fact, aside from issuing the currency, the ECB is, through the ESRB, playing an ever-larger role in macroprudential policies. At the same time, through its position in the SSM and in the troika, it is increasing its direct influence on financial policies. Moreover, since it is an independent, well-respected institution supported by most member states, it is capable of keeping its policy autonomy and of implementing the single-policy stance across the euro area. Nevertheless, in order for the euro area to have a sustainable monetary union in the long term, the ECB would have to act as an unconditional lender of last resort for sovereign states in exceptional circumstances (as the Fed does in the US and the Bank of England does in the UK).[5] This will only be possible if its mandate is modified to consider deficit financing in the event of a speculative attack. Furthermore, since the euro area as a whole has to deal with significant growth and unemployment challenges, the mandate of the ECB will need to focus not only on inflation but also on including provisions to encourage economic growth, for which coordination with the fiscal authority, the Eurogroup, and the other macroeconomic policy institutions will be necessary.

Creating an economic union

The "open method of coordination" conceived in the Lisbon strategy fostered the convergence of the economic structures of different euro member states but did not provide the right incentives to introduce structural reforms (Molina et al., 2010). Therefore, the European policies that have been implemented to guarantee structural reforms have largely failed. In fact, even though many countries have adopted reforms, they have mainly done so at a national level as a response to market pressures or to the troika's dictates. Nevertheless, in order for the euro area countries

5. For a theoretical justification see De Grauwe (2012a).

to live according to the strictures imposed by the single currency, structural reforms are necessary. The nature of these reforms and the priorities for action will largely be determined nationally in order to respect European countries' wide diversity of economic structures. Nonetheless, coordination across the euro area will be necessary since these countries are interconnected and a failure to implement the reforms at national level can have significant consequences for other states. In fact, in the absence of appropriate coordination, any attempt to close the competitiveness gaps between the euro area countries will fail.

The design of structures and processes to boost coordination and preserve a national focus for action will not be easy. However, an institution such as the Eurogroup (whose president would also lead the central fiscal authority) is needed to coordinate structural policies in the euro area. Since the process of delivering structural reforms is time consuming, the Eurogroup should set action priorities for each country over a multi-year programme. Moreover, it should carry out an analysis of the spillovers that national structural policies have from one country to another and create incentives to encourage countries to implement reforms (with the power to apply sanctions). Furthermore, it should set minimum standards on major public policies (spending on R&D, transparency and meritocracy in public administration, and the fight against tax evasion), coordinate policies in key areas (labour market regulation, pensions and taxation), and standardise and harmonise data collection in all areas of public administration to build trust in the public finances of all euro area countries (through periodic visits to ensure that there is progressive convergence and increased transparency). Finally, if resources are needed to finance structural policies, the fiscal capacity should provide them.

This forum will need member states to fully engage with and take ownership of it since they have the leading role in the implementation of decisions. To ease the reform processes and create positive incentives for them, fiscal capacity resources could be used to co-finance some of the reforms that need funding. Since enforcement will be a crucial matter, a way to safeguard it could be for the euro area countries to sign contracts with the Commission and commit themselves to implementing structural reforms if they are provided with specific resources to finance them. If properly designed, this proposal, which has been made by the Commission, could give countries positive incentives to engage in structural reforms in periods of normality (structural reforms and austerity measures for countries under an ESM programme are already being requested by the troika). At first, in order to determine priorities and identify necessary reforms, the macroeconomic imbalances framework could be used. Nevertheless, for full coordination across the range of economic policies to be achieved, the mechanism should take a step forward and act *ex ante* and not *ex post* (like the MIP) to guarantee real economic convergence and avoid macroeconomic spillovers and competitiveness misalignments.

Policy coordination

As the crisis has shown, there are major flaws in the coordination of macroeconomic and structural policies, particularly in the euro area. These need to be addressed for the design of the single currency to work. Therefore, a strong mechanism for coordinating fiscal and monetary

policy is required for the EMU to be effective. Moreover, and as mentioned above, macroprudential policies need to be well aligned with the single monetary policy and with fiscal policies in the event of complications. And, at the same time, strong coordination is needed between structural policies and fiscal and wider macroeconomic policies.

To reach this level and breadth of coordination, a number of European institutions (each with its own mandates and responsibilities) will need to take part, since the process will be long and difficult for several reasons. But it is important to note that strong national interests will play a major role in designing some policy areas. The participation of the ECB (and the single monetary policy) will be particularly problematic, since it has constitutional independence. However, ineffective coordination across all arms of economic policy could lead to inefficient policy settings and even to pressures similar to those seen recently. At the moment, the Eurogroup, despite being based on an intergovernmental approach, is the institution that is best suited to coordinating national macroeconomic policies and assessing their impact on the policies of the new central fiscal authority and the ECB, as well as the influence that these policies have on macroeconomic policies.

Given the responsibilities of the ECB and of the central fiscal authority, regular dialogue between them is necessary. It should happen before significant budget statements and interest rate decisions in order to ensure an exchange of information between the two bodies. This dialogue would cover the crucial features of the ECB's remit that have fiscal and wider macroeconomic consequences, which include liquidity policy, supervisory tasks and the resolution of failing banks, as well as core monetary policy and its impact on the euro exchange rate. In addition, the central fiscal authority would add its responsibilities for national budgets, fiscal transfers, debt issuance, and the overall fiscal stance in the euro area to the discussion. The dialogue would greatly contribute both in institutional and policy terms to the provision of a stronger level of coordination of fiscal policies in the euro area and to the acknowledgement of the interplay between fiscal policies and the single monetary policy. However, the ideal situation would be for the dialogue to go a step further and address macroprudential and structural policies.

In short, better and stronger coordination of policies across the diverse policy arms is needed and is only achievable if there is improved coordination between member states and European institutions and between all the European institutions concerned, such as the Commission, the Council, the Parliament, the ECB, the Eurogroup and the central fiscal authority.

Towards political union?

The outbreak of the crisis has led to a centralisation of responsibilities. As a result, a significant amount of power has shifted from the national to the European level. Meanwhile, whereas creditor countries have increased their say on European economic decisions, debtor countries have become "policy-takers". To remain in the euro area and have access to financial support, the countries that have been most affected by the crisis have adopted centrally-determined policy changes. However,

this transfer process will eventually be extended to all countries as mounting pressures to adjust national policies to set standards centrally are being backed up by stronger sanctions for non-adherence.

What this paper proposes goes beyond the recommendations of the "Four Presidents Report" or the European Commission's Blueprint,[6] and demands a new overarching political solution that will boost trust and solidarity among the countries in the euro area. This will necessarily mean a greater transfer of sovereignty from member states to European institutions, which will inevitably lead to a "democratic deficit". Since the deeper economic integration needed to sustain the euro will increase this deficit, some degree of political union will be required in the long term to legitimise the transfer of powers and deal with the legitimacy problem. Therefore, the goal would be to create a European *demos* (similar to a European Federation of States or a United States of Europe) with the capacity to directly elect its leaders and defend European interests (national interests will gradually become blurred). These proposals mostly suggest a reduction in the powers of national parliaments and an increase in the powers of the European Parliament and of the other EU institutions.

In the near future, the intergovernmental approach embodied by the European Council will be alive due to the history of the EU. Nevertheless, the European Commission will need more legitimacy and, in order to become a truly legislative power, the powers given to the European Parliament will need to be greater than the Lisbon treaty envisaged. Although it will still be possible to progress with intergovernmental treaties (as occurred with the ESM and the fiscal compact), citizens will eventually need to see themselves and their vote represented in the decisions taken in the new economic governance of the euro area, where the say of European institutions will be greater than that of national parliaments. A possibility would be for the president of the Commission to be democratically elected in direct elections or, as happened in the case of Jean-Claude Juncker in 2014, to be elected indirectly through the European Parliament. In either case the Commission would resemble a real executive branch of government rather than a technical body with no political mandate, since it would respond to the votes and the political will of European citizens, thus making decisions closer to voters' preferences.

These proposals will take coordination of core economic policies within the euro area to a higher level. As a consequence, there will be an increase in the divide between euro members and non-members. The interactions between the EMU and the responsibilities of the single market will further harden this divide. And, taking into account the variable geometry of decision-making in the EU, this would heighten demarcation disputes and tensions between the increasingly large group of "ins" and the increasingly small group of "outs".

Finally, it should be mentioned that many of the proposals in this paper require treaty change. Given the current political situation in the eurozone, which is characterised by the rise of anti-European sentiment, European leaders are likely to opt for change through intergovernmental agreements. But treaty change at some point is the only realistic path to greater legitimacy and a more symmetric union. Euro area leaders have to start communicating this to their electorates and get public opinion on board.

6. Van Rompuy et al., (2012), "Towards a genuine economic and monetary union". http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf

At the end of the day, eurozone citizens need to be given a real choice between continued fragmentation, which leaves the euro exposed to structural weaknesses and recurrent crises, and greater integration, which pools more sovereignty and at the same time strengthens the governance of the EMU.

Conclusion

The eurozone crisis has shown that the governance structure underpinning the euro was incomplete. In the original design of the Maastricht treaty the importance of labour and product flexibility and mobility was underplayed and the significance of divergences in competitiveness between countries within the single currency area largely ignored. Over time it has become clear that current account imbalances within the euro area were as much of a problem as fiscal unsustainability. Moreover, the monetary union was supposed to work without fiscal union, banking union, a lender of last resort or a bailout fund. As anticipated by the theory of optimal currency areas, when the crisis hit, the eurozone could not respond.[7]

The lesson is clear: monetary unions should be sustained by adequate political institutions and governance structures capable of responding in times of crisis. Specifically, a monetary union needs to be underpinned by a fiscal union, a banking union and some degree of economic union. However, as has been explained, these requirements imply some degree of political integration to legitimise the enormous pooling of sovereignty necessary to achieve these goals.

Despite these shortcomings, it is worth mentioning that euro area countries have shown an incredibly high degree of political commitment to the euro project. Understanding the basis of this political commitment is key for assessing the future of the euro. As a number of scholars have shown (Marsh, 2013), the EMU was not only an economic project. It was a political project that has to be analysed in the wider context of the EU integration process. Seen from that perspective, the EMU was just another step towards "ever closer union". It was a way to consolidate the internal market and to proceed in the process of European integration under the functionalist logic by which the founding fathers of the EU envisioned the future of a united, peaceful and prosperous Europe to be built in small steps (Spolaore, 2013).

Early discussions about the single currency did acknowledge the need for political union in the long run. Chancellor Helmut Kohl argued that "Political union is the indispensable counterpart to economic and monetary union. (...) It is fallacious to think one can sustain economic and monetary union permanently without political union".[8] More recently, De Grauwe has synthesised this idea by claiming that "The euro is a currency without a country. To make it sustainable a European country has to be created" (De Grauwe, 2012b).

This shows that EU leaders acknowledged the need for a political union to sustain the EMU. However, in the early 1990s the political agreement to go that far did not exist, mainly because France was reluctant to give up so much fiscal and economic sovereignty. This, in turn, led Germany

7. See Krugman (2012).
8. Speech to the German Bundestag Parliament, 1991.

to push for a limited model of monetary integration based on an independent and orthodox central bank, tight controls on fiscal policy and no fiscal transfers (Marsh, 2009).

The current eurozone crisis appears to be an opportunity to go beyond the weak original design of the euro and to cement the EMU by adding the necessary elements of a fiscal, banking, economic and political union, as well as by strengthening policy coordination and expanding the role of the ECB. This paper has made a number of specific proposals for proceeding in that direction.

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EMU GOVERNANCE AND THE LIMITS OF FISCAL POLICY COORDINATION

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Introduction

The financial and economic crisis in the euro area that began in 2010 revealed critical flaws in the existing EMU governance system. Effective market risk-sharing mechanisms and fiscal stabilisation mechanisms—both typical features of accomplished federations—were fundamentally overlooked in the design of its architecture. While the absence of such mechanisms seems irrelevant in 'normal times', in times of crisis it means the EMU is endowed with very limited capacity to respond to shocks.

As the severity of the crisis unfolded, unprecedented measures became necessary. This resulted in an overhaul of EU economic governance that did not, however, lead to radical transformation. Admittedly, the crisis and the events that followed fed a large debate about the need for deeper integration, which should include both political and fiscal union. Indeed, there is consensus that a common currency makes it desirable to also have a common fiscal policy and a political union. In 2012 the four EU presidents (presidents of the European Commission, European Council, Eurogroup and the European Central Bank) stated that the establishment of the banking union constituted a concrete step towards fiscal union and that further integration in this sense is desirable.

The argument for moving towards fiscal and political union is mainly driven by the fact that in reality we have no experience of properly functioning monetary unions that are not fiscal and political unions. Existing monetary unions are endowed with a common budget and are true federations. Notably, this is the case of the US, which is certainly considered a benchmark for the future of the EMU, but also of Germany and others.

Besides the banking union no dramatic advance materialised and further moves in this direction remain unlikely because of both the lack of political will and uncertain citizen support. The specific measures taken ranged from the strengthening of coordination of macroeconomic policy to the creation of financial assistance mechanisms and the redesign of financial market regulation. In this process the most prominent feature of the governance system has remained the same: the E(M)U governance system is

a rule-based system. Changes introduced from 2010 onwards reaffirmed such a principle as a main pillar of the system but put emphasis on two dimensions: economic policy coordination and macroeconomic surveillance.[1]

In the original governance framework (the Stability and Growth Pact) coordination is mainly intended to be a set of rules with the purpose of preventing *ex ante* fiscal shocks or lowering the probability of their occurrence by defining stringent limits to ensure the long-term sustainability of public finances. The new framework embedded in the six-pack and the two-pack reaffirms this idea and extends it to include rules designed to deal with shocks. In this context coordination is also intended as a means to get firm commitment from member states for certain policies.

This paper addresses the question of why fiscal coordination is necessary and what it can achieve from a macroeconomic point of view. It is argued that while the existence of cross-country spillover effects is the main economic rationale for coordination, it should be recognised that there is still little understanding of how spillover effects work. The crisis showed that the transmission mechanisms through which spillover effects materialise vary depending on the economic conditions, which implies that too-stringent rules may lead to sub-optimal outcomes.

The rest of this paper starts by critically reviewing the existing EMU governance framework.

An overview of the EMU governance system

The governance system in place since the inception of the EMU was explicitly designed as a rule-based system whose characteristics fit the EMU structure well.[2] The first is that it allows for the de-politicisation of decisions. The application of common rules with defined targets, numerical thresholds and automatic mechanisms for correction eliminates (or at least reduces) the need for political decision-making at EU level, where no federal institutions exist; political power is dispersed and national interests may be divergent. Political decisions are left in the hands of the national governments. They ultimately hold the political responsibility for choosing the policies to meet the requested targets and satisfy the established thresholds.

This system also has another advantage: it offers a way to deal with mistrust among the member states. The prevailing notion that the roots of the crisis were to be found in the bad management of public finances,[3] meaning countries needed to put their own houses in order, drowned in a rising tide of mistrust among member states about one another's reliability with regard to their responsibilities. The commitments that emerged after 2010 sought to respond to this mistrust by hardening the treaty's already-existing commitments.

Some also argued that rules,[4] even stricter rules, and unquestionable definitions have always been typical of the German approach to deal-making, including that of the EMU project, in contrast to the political lenience more typical of the French approach.

1. The timeline of this process is set by the European Semester, the main pillar of the governance framework.
2. See Alcidi et al., (2014).
3. As well as some misreporting in official data.
4. See, for instance: Heipertz, M. and Verdun, A. (2005).

Once the reasons a rule-based system is key for the E(M)U are acknowledged, the question posed by the crisis is whether rules can govern in a political and fiscal vacuum, and more generally, whether macroeconomic matters can really be depoliticised. The recent history of EU governance, reaffirming rules at the centre of the system, suggests that this is assumed to be the case. However, while before 2010 rules were essentially designed to prevent crises, the changes introduced afterwards added rules meant to respond to situations of crisis. On the one hand, this approach is justified by the need to ensure that countries behave to ensure the proper functioning of the union. On the other, it seems to contrast with the notion that flexibility and discretion are required for crisis management and to disregard the growing dissent vis-à-vis rules. Indeed, the duration of the crisis and the depth of the recession have severely put into question the desirability and the benefits of common rules, both among citizens and some policy makers.

This was reflected in the policy debate by a shift from the idea of shared rules towards the creation of common tools to mitigate the effects of shocks, such as the creation of the banking union and the debate around the idea of fiscal capacity for the EMU and the unemployment insurance scheme. However, sharing resources without a central fiscal authority in charge of taxation and redistribution remains a sensitive issue, seen as a way to de facto transform the EMU into a transfer union.

Then the question is what, in economic terms, can be achieved through fiscal coordination within the current framework. Section 3 addresses this question, but, before that, the following section presents an overview of fiscal coordination and its links to spillover effects in the current governance system.

Coordination and spillover effects in the current governance system

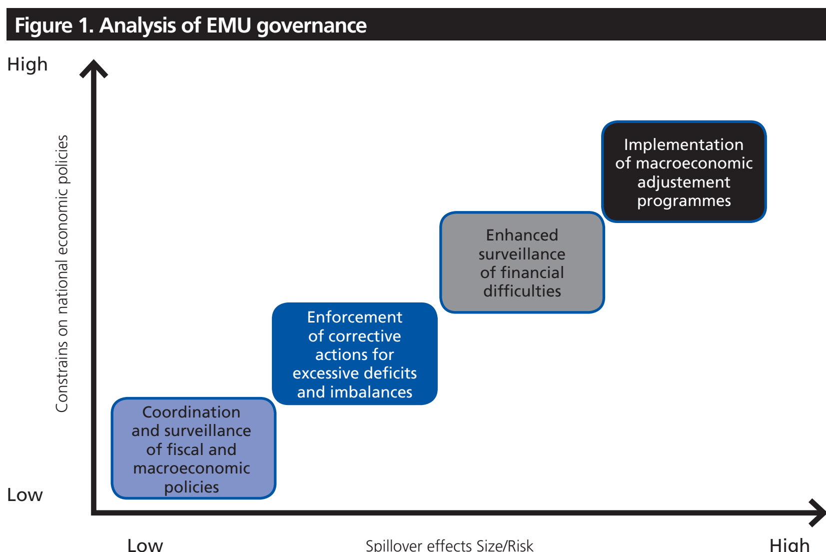
If one were to find a common thread in the institutional changes of the EMU economic governance in response to the euro area crisis, it would certainly be the attempt to strengthen EU coordination and surveillance on economic matters. This has resulted in the formulation of different procedures, i.e. macroeconomic adjustment programmes, enhanced surveillance of countries in financial difficulties, corrective actions for excessive defects and imbalances and coordination and surveillance of fiscal and macroeconomic policies, defined in the six-pack and two-pack. Each of them features different degrees of EU intrusion into national economic policies, triggered under different conditions and built in such a way that different EU actors play different roles in affecting the definition of national economic policies.

Figure 1 plots these procedures according to the degree of constraints imposed on national policies at EU level (vertical axis) against the possible spillover effects (horizontal axis), i.e. the risk that an idiosyncratic shock generates negative spillover effects on other countries and/or the EMU as whole.

The objective of this exercise is to visually illustrate how the degree of interference from the EU at a national level, and hence, broadly speaking, of

coordination and surveillance, is related to the risk of spillover effects. This is important because the rationale for coordination is in the existence of spillover effects. As expected, a clear positive correlation emerges from the picture: the level of obligations member states have or can be subject to (measured along the vertical axis), as foreseen in the procedures, increases when the risk of (and possibly the size of) the spillover effects is higher.

Figure 1. Analysis of EMU governance



Source: Based on Alcidi et al. (2014).

The graph shows that in times of calm when the risk of spillover effects is small, the interference at EU level in national policy decision-making is limited. By contrast, countries under macroeconomic adjustment programmes are those for which the constraints on national policies are the most stringent but also those that could represent the largest source of risk for other countries.

What the chart does not say is whether the absolute level of coordination associated with each procedure is optimal and if the approach works well in practice. The recent experience of the countries under the programme, such as Greece, does not seem to robustly support the idea that greater intrusion leads to improved capacity to deal with externalities. But the experience of countries like Ireland and Portugal may suggest otherwise and the counterfactual outcomes are impossible to estimate.

Figure 1 also helps us to understand the limits of the rule-based system and the idea of the depoliticisation of EU decisions presented in the introduction. It suggests that when moving away from the axes' origin, the rule-based system designed to prevent crisis is failing and that the objective of the rules in place is to govern crisis management and crisis response. The crisis has shown that under such circumstances decisions of a political nature become inevitable and for those decisions due accountability must be ensured.

The next section looks in more detail at the spillover effects and the macroeconomic conditions under which they work and what this implies for coordination.

Fiscal policy coordination in a monetary union and spillover effects

In the EMU, as monetary policy can no longer respond to country-specific shocks and factor mobility alone is not sufficient,[5] a system of cross-border fiscal transfers is often proposed as a solution.[6] This option has always been politically sensitive and remains unlikely despite the size of the recent crisis.

From an economic point of view, if one excludes forms of common and centralised resources, coordination of national fiscal policies is considered the optimal response for the purpose of macroeconomic stabilisation of spillover effects emerging from country-specific disturbances. This is the case because a fiscal impulse in one country may impact output and prices in another country through trade channels (imports), price channels (relative price changes), interest rate channels (the common interest rate changes in response to situations that are specific to one country) and financial market channels (e.g. contagion). In this context a cooperative approach reduces the discretionary use of fiscal policy but should also lead to a superior outcome for the EMU as a whole.

This is the fundamental argument that justifies fiscal coordination in the EMU.

In practice, the optimal degree of fiscal coordination depends both on the trade-off between the specific needs of national governments (due to heterogeneous preferences, national constraints or specific macroeconomic shocks) and on the magnitude of the fiscal (but not exclusively) spillovers.[7] Berrell et al. (2007) demonstrated that the case for fiscal policy coordination is meaningful only in the short run. In the long run, spillovers are expected to become ever smaller as a consequence of financial liberalisation, although the crisis showed otherwise.[8]

This is consistent with the argument made by Allard et al. (2013). While at its inception, it was thought that the EMU would at most face moderate country-specific shocks, made rare by a common commitment to fiscal soundness, in reality not only have there been larger and more frequent idiosyncratic shocks but also more idiosyncratic policies and the associated spillover effects were not sufficiently taken into account.

In addition to this, recent extensions of the literature on optimal currency area theory stress that differences in the structural and fiscal policies can cause negative spillover effects from less virtuous to more virtuous countries and end up interfering with the monetary policy and the overall proper-functioning of EMU.[9]

Besides the optimal degree, a key point relates to the concept and content of policy coordination. This is not clearly defined in the treaty. Within the European Semester, the European Commission has to assess whether policies planned by national governments are 'appropriate' and issue recommendations accordingly. This is mostly based on the potential of such policies to meet certain targets. However, there are circumstances in which the assessment required is more complex and it is neither explicit nor clear whether the principle guiding the evaluation is the ad hoc optimisation of the overall good/welfare of the union or rather the

5. Factor mobility should work as a risk-sharing mechanism so that the risks and potentially the losses of certain shocks are shared and dispersed across the union. This way, the impact of the shock on a specific country is low. In the E(M)U, labour mobility has always been low and this did not significantly change after the crisis (see Barslund and Busse, 2014). Capital mobility, broadly measured by capital flows, was very high before the crisis, mostly in terms of cross-country bank exposure. In practice, however, this did not provide a proper mechanism for risk-sharing, exactly because of the forms taken by capital mobility and market integration.
6. For example by Hammond and von Hagen (1995) and Beetsma and Bovenberg (2001).
7. See Alesina and Wacziarg (1999).
8. These results were heavily dependent on structural assumptions about the formation of expectation and about the degree of liquidity constraints.
9. Beetsma and Giuliodori (2010).

idea that coordination always leads to a better outcome. This is relevant because there might be circumstances where spillover effects are of little importance and the need for coordination is small.

In order to illustrate this idea it may be useful to consider the following example. There is little disagreement among economists that in general in the long run it is better to limit deficits and to keep debt levels low. However, it may be optimal for this general long-term goal not to be pursued under all circumstances.

The question of whether deficits should be further reduced once financial market tensions abate is still important. According to De Grauwe (2014), to answer the question it is essential to make the distinction between supply and demand shocks. He argues that during the 1970s and 1980s Europe's economy was hit by negative supply shocks coming from the sharp swings in oil prices. The expansionary policies (demand policies) chosen by some countries were not the appropriate response and resulted in high inflation and the accumulation of large amounts of debt. By contrast, since 2010 the euro area has been confronted with a negative demand shock. This implies that an expansionary fiscal policy might be the appropriate policy response to compensate for the shortfall in demand. Such an argument is reinforced by the fact that, with policy rate at the zero lower bound, the effectiveness of monetary policy is dramatically diminished. Overall, the argument implies that the long-term goal of stable public finances may at times conflict with short- to medium-term goals, namely that of stabilising demand. Neither the Stability and Growth Pact nor the Treaty on Stability, Coordination and Governance take this into consideration. And they probably cannot do so without tremendously increasing their complexity.

Overall, while there seems to be agreement that cross-country spillover effects make fiscal coordination desirable,[10] the optimal policy response depends on the nature of the shock (e.g. demand versus supply, temporary versus permanent) and there is no complete understanding of how they are transmitted to other countries, nor even how to identify the signs of their impact, which makes their net effect uncertain. Moreover, the crisis has shown that additional non-traditional channels may exist in turbulent times, with financial market mechanisms likely to play a prominent role, and that traditional channels may work in a different way according to the macroeconomic and financial circumstances, as they interact with other channels. This is not accounted for in the existing governance framework and, because of the natural rigidity of the rules, is unlikely to be the case in the future.

The next section illustrates how the same shock can impact different economies in different ways according to the economic circumstances/regimes.

Fiscal policy coordination and state of the economy

In this section it is shown that the need for policy coordination (and the need to impose limits on the degree of freedom for national fiscal policy) depends on the economic and financial market regime of the time.

10. This argument is consistent with the approach at EU level. The European Commission, when explaining why *ex ante* fiscal coordination is desirable, uses the following argument: "Major economic reforms in one Member State can cause economic spillover effects on other Member States. Such spillover effects are all the more relevant in an Economic and Monetary Union, as the crisis has underlined. Major economic reforms can produce economic spillover effects on other Member States via trade and competitiveness and via financial markets".

Table 1 summarises the possible spillover effects of an increase in the fiscal deficit in one country on other countries of the monetary union using two key variables – debt and demand – in three different circumstances: 'normal times', times when the monetary policy is ineffective and times of crisis.

Table 1. Spillover effects in a monetary union

Relevant variables / State of economy & financial markets	Debt (stock) in the country of the shock	Demand in other countries
Normal times	Not material?	Uncertain effect
Zero interest rate (policy rate)	Not material?	Positive
Crisis times: High risk premia	Very strongly negative	Strongly negative

Source: Based on Alcidi and Gros (2014).

During normal times (first row), when financial stability is not at risk, the level of debt does not play an important role, unless of course debt sustainability is an issue for the country. In this case, there is no spillover effect even if financial markets put a premium on a higher debt level. Countries with a high level of debt may face higher debt service costs, but that should have an impact neither on other countries nor on the stability of the entire financial system of the euro area. One of the objectives of the banking union is precisely to create these conditions: where a country's financing difficulties remain confined to that country. This is done by favouring market risk-sharing mechanisms that reduce the risk that an idiosyncratic shock is transmitted to the rest of the euro area and even amplifies it.[11]

In normal times, the spillover effects of a fiscal shock could be negative or positive, as argued formally in Belke and Gros (2009). A fiscal expansion, for instance, in any one country leads to an increase in domestic demand, which increases exports in the rest of the euro area. However, because of the way it affects prices this increase in demand may also induce the monetary authorities to tighten the policy stance. This has an impact on all countries and makes the net effect of the initial shock uncertain. For instance, the impact of an expansionary fiscal policy in Germany on other countries, say, Portugal or the Netherlands, depends on the strength of the trade linkages and the degree to which monetary policy affects domestic demand. In this illustrative case it could be argued that for Portugal, whose trade linkages with Germany are rather weak, the negative impact of tightening by the ECB could outweigh the increase in export demand from Germany. By contrast, for the Netherlands, the result might be the opposite given the very intense trade relationship this country has with Germany. This suggests that the rationale for an explicit *ex ante* coordination of fiscal policy and consequent policy reaction prescriptions is rather weak during 'normal' times.

This argument no longer holds when one considers that the policy rate is at zero lower bound and the economy is in a 'liquidity' trap situation (second row). In this case a fiscal expansion should have an unambiguously positive impact on the other countries because the ECB would

11. See, for instance, Gros (2013).

not increase rates in response to an increase in demand in one country (Germany in the example above). This provides a rationale for *ex ante* fiscal policy coordination and, in particular, expansionary policies in the short term.

In the case of a financial crisis (third row), when risk aversion is high the nature of the spillover effects changes radically. Dysfunctional financial markets tend to pass on and amplify shocks, as was shown during the Greek crisis in 2009/10. Under these circumstances an expansionary fiscal stance in any one country can have a large negative impact on other countries and throughout the entire union if it leads to herd behaviour and panic. Moreover, in this context the size of the public debt matters greatly. The higher the debt, the stronger the negative impact of high risk premia and the larger the risk of contagion and the potential burden on other countries if financial support to the country has to be provided.

This brief description of the likely spillover effects of a fiscal shock illustrates how the nature of these spillover effects changes according to the regime under which the economy of the euro area is working. From an economic point of view, this implies that the rationale for policy coordination changes from one regime to another.

During normal times the case for explicit *ex ante* coordination is weak as long as the general thrust of policy is not towards the accumulation of unsustainable debt levels. During a financial crisis, by contrast, the case for fiscal policy coordination is very strong. The most difficult case is that of a liquidity trap when short-term considerations may conflict with long-term concerns.

The general conclusion is that one size does not fit all. The degree of economic policy coordination must be adapted to the different possible economic circumstances. The new system of economic policy coordination emerged as a response to the euro area crisis and is hence possibly affected by the rationale guiding such circumstances. Not all of its elements will remain appropriate once more normal times return.

Conclusions

This article points to the fact that from an economic point of view cross-country spillover effects are the reason why fiscal coordination is desirable and this seems to be taken into account (with all the difficulties) by the existing system of governance.

However, it has also emphasised that the optimal degree of policy coordination depends crucially on the nature of the shock and on the macroeconomic and financial market conditions. All in all, the result is that the attempt to coordinate too much and too tightly can lead to excessive attention on procedural issues at the expense of the substantive results to be achieved. The degree of economic policy coordination must be adapted to the different possible economic circumstances.

The new system of economic policy coordination which emerged in response to the euro area crisis maybe too heavily affected by the logic guiding times of crisis and not necessarily optimal for all circumstances.

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CAN THE EUROZONE'S ECONOMIC GOVERNANCE COMBINE POLITICAL ACCOUNTABILITY, LEGITIMACY AND EFFECTIVENESS?[1]

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After years of economic crisis, resulting in significant changes to economic governance at EU level, especially for the eurozone, the time has come to consider the longer term political and economic implications of this new situation for the economic integration process. Not only to determine how well the system is likely to function but also what more needs to be done to ensure long-term stability and to provide the EU institutions with sufficient political legitimacy to carry out this new role.

This article does not consider abolishing the euro, based on the conviction that introducing the euro created a path to dependency that makes trying to unpick the seams of the process extremely costly. While, economically, the exit of one eurozone member state might conceivably be manageable (but costly, especially for that country), the long term political costs might end up unravelling the whole European integration process, with the potential for a bankrupt and politically unstable state outside the euro but still within the EU. However, the status quo situation is still unstable, politically and economically, and needs further policy reforms.

Governing reluctant member states

The crisis has shown that the EMU has created an even higher degree of interdependence, with imbalances and lack of convergence – partially inflicted by countries themselves – threatening the stability of the EMU as a whole and thus driving the need for (politically controversial) support for economically weaker member states. The key policy levers to influence these imbalances are at member state level rather than being controlled by the EU institutions. It follows that one of the key features of the post-crisis eurozone governance framework is the need to directly influence the behaviour of member states, in particular in terms of fiscal policy choices and structural reforms.

To address this need, the new governance framework mostly relies on a legalistic, rules-based approach, i.e. an EU legal framework with sanc-

1. This article builds on Zuleeg (September 2014).

tions for non-compliance. In many ways, this represents a halfway house between market forces and 'federalisation', i.e. pooling sovereignty at EU level in an executive that can enforce common policy decisions. Not only is a rules-based system the EU's traditional response (its backbone is legislative, after all), but both market-based and federalised solutions were seen as undesirable: market-based solutions might lead to sovereign defaults and banking system troubles, while federalisation was seen as an undesirable transfer of sovereignty that would be constitutionally tricky, as fiscal policy touches on some of the most fundamental functions of the nation state, and would be politically impossible to sell to northern European electorates, as it would have to include the mutualisation of public debt.

However, the new EMU governance framework is not purely rules-based: it also contains new provisions that are more akin to the open method of coordination. In the new European Semester process, the main driver behind member state compliance is 'peer group' pressure, i.e. being monitored by fellow heads of state and government. However, in the past these methods have not worked successfully and this seems to be the case once again for the implementation of the Country-specific Recommendations (CSRs). Studies suggest that implementation of the CSRs is patchy at best. In essence, those member states that want to implement the CSRs do so, while the rest can safely ignore them without the fear of sanctions.[2] While the European Semester process could be improved, for example, by putting a stronger focus on a smaller number of key recommendations, this structural deficit of a lack of enforcement mechanisms will continue to limit the effectiveness of CSR implementation.

In one area of the new governance, enforcement mechanisms have been ever present: the programmes introduced by countries requiring public finance support, with implementation monitored by the troika of European Commission, ECB and IMF. However, the troika mechanism has been highly controversial, because of the loss of sovereignty it implies. Consequently, many have criticised the troika and the recent victory of Syriza in Greece can, in part, be interpreted as a backlash against the perceived lack of legitimacy of the troika's actions, which is reinforced by the exclusion of the support and implementation systems in programme countries from the community method.

The limitations of rules-based systems

For the foreseeable future, it therefore appears likely that the EU will rely on the tried-and-tested method of rules-based governance. But the effectiveness of the system is still questionable, as rules-based systems suffer from a number of limitations, including:

- questions about how to pick appropriate rules/targets, adapted to both the economic environment and country-specific conditions;
- the way that rules suffer from low anticipatory powers: they often address past crises rather than coming ones. To deal with emerging risks, it is necessary to have significant instruments that can be employed quickly (or even automatically) rather than having a set of inflexible rules;

2. Theoretically, the lack of implementation of CSRs might have some consequences, for example in terms of EU structural and investment funds. But it is difficult to envisage this being implemented strictly.

- the perennial question of enforcement mechanisms, especially since, at EU level, enforcement is often reliant on the willingness of the heads of member states to censor or even fine their peers;
- whether a country's failure to meet a target is down to willingness or capacity to deliver and under what circumstances there needs to be flexibility, and who decides on it;
- and that the available instruments, both old and new, are too complex and therefore difficult to understand for policy-makers that need to quickly apply and comply with the rules. This complexity is an additional factor that leads to low automaticity that obstructs the necessary degree of *ex ante* support for the prevention of new economic and financial crises.

The rules-based system is further complicated by the need to interpret rules which always opens up potential disagreement. While the system offers the opportunity of taking the legal enforcement route, this requires the political will to take countries to court, as well as patience, as rulings take time to be delivered. In addition, there are questions over whether a court with legal rather than economic competence is well-placed to rule on matters of economic governance. In addition, the reliability of monitoring information is critical to ensure consistent implementation of the rules. If there is a degree of interpretation – in conditional rules, for example, which are based on some form of relative concept rather than a simple, absolute target – it can be difficult to reach agreement on how the data should be interpreted.

Given the difficulties in changing the EU's strategic direction, it is also very challenging to change any of the rules that have been written into the EU treaties. Furthermore, it is nearly impossible to take into account country-specific conditions and circumstances, or changes in the broader macro-environment. This raises a number of crucial questions: Is the same inflation target still appropriate in a situation where deflation is threatening? Is it right to focus strongly on public debt? Is a deficit target of 3% the right one for all countries, given divergent growth performances and debt financing costs? Again, if, for any of these rules there is a need to consider more flexibility, who is empowered to make such a decision?

For some countries, it seems that the main objection to any economic governance arrangement is more the fact of attempting to impose rules at European level than disagreement with the content of the rules themselves or how flexibly they are applied. In essence, under the guise of flexibility or reductions in austerity, countries may aim for a repatriation of fiscal powers, which would undermine effective fiscal coordination at eurozone level, as well as undermining the underlying political bargain—debt financing support only with attached conditionality.

Another key challenge is to ensure compliance with the rules by both small and big countries to safeguard the long-term credibility of the new governance system. Previous experience with the Stability and Growth Pact shows that if large, powerful countries do not comply with the rules, the remaining countries will soon follow suit. Recent debates already seem to show that some member states think the rules apply less to them than to others, as illustrated by the debates about the flexibility of sticking to the 3% deficit limit (prompted by large countries with public finance problems) and recent discussions on export surpluses, which

provoked highly negative reactions in Germany, despite being fully in line with the recently-created governance instruments. Any exceptions to the rules, for example regarding flexibility, should only be decided at the eurozone level and be equally applied to all member states.

But the lack of *a priori* flexibility in rules-based systems is a particular challenge in times of crisis and uncertainty. It raises the question of who makes the decision on whether rules can be suspended or eased in such instances. In the case of fiscal governance, any such decision (or the decision to enforce the rules) by the Commission is likely to be challenged, especially by the bigger countries. However, if it is down to the Council, it is difficult to see heads of state and government holding their peers strictly to account.

In the current situation, the rules need to be adapted to encourage more private and public/social investment. But this needs to be done while still maintaining the integrity of the governance framework as a whole. The only way to do this consistently in a rules-based system is to amend the rules. In this case some form of Golden Rule, excluding productive investment from the deficit criterion, would be a feasible, if politically contentious, option. This would need to be accompanied by a framework to define what falls under social/public investment for the purpose of such a Golden Rule. But, yet again, significant hurdles need to be overcome, such as how to define what falls under the rule, determining who makes the final decision on it, and ensuring its implementation relies on objective, independent evidence.

But the difficulties with a rules-based, legalistic system go further than this. In the policy areas which the EU now needs to cover which are close to the heart of national decision-making systems, the reliance on a rules-based approach is unlikely to function well. While, at times, adhering to European rules in politically sensitive areas can be politically useful in order to shift responsibility for unpopular measures, at other times the political cost of compliance outweighs the consequences of breaking the rules, especially for the more powerful countries.

A game-theory view of economic governance

The challenge of implementing rules in a dynamic and uncertain environment should not, thus, be seen as a legal problem. It is, in reality, a political economy problem and here it can be useful to borrow some concepts from game theory, political economy theory and transition economics to highlight some of the fundamental political conflicts that limit the further development of eurozone governance.

Political feasibility: The crisis management strategy chosen by the EU to deal with the euro-crisis has not taken political feasibility sufficiently into account, as is clearly demonstrated by the election victory of Syriza in Greece. This should not have been unexpected. After all, in a situation with rapidly falling living standards and few positive economic prospects, the messages of populists will gain traction. A crisis management strategy must thus build in the need to create constituencies for reform, as well as providing populations with realistic prospects of future improvement.

Time inconsistency and moral hazard: Agreements based on the commitments of member states suffer from moral hazard problems, i.e. the tendency of countries, once they have received the support they need, to backtrack on the more difficult reforms and commitments they have previously made. This can be especially difficult when governments change. As a result, any support becomes time inconsistent and the result is sub-optimal, with no support and no reform.

Bounded rationality and asymmetric information: There are a number of information limitations which arise in such complex governance frameworks. This is aggravated by information asymmetry, where national governments hold more information than the institutions or the other member states, for example, on whether reforms are implemented or whether there is only on-paper compliance.

These issues, in combination with the distrust between member states which arose from the euro-crisis, imply that there is a prisoner's dilemma at the heart of EU policy: without support, there is no reform, but without reform there will be no support. In the EU, traditionally, Germany has been able to overcome the prisoner's dilemma by making the first move, with a focus on the longer-term national interest, but Germany no longer takes this role, having become more 'normalised', i.e. looking out for more narrowly-perceived national interests.

The final result is inertia. Member states try to muddle through without having a long-term agreed-upon vision, necessitating ongoing ECB action to prop the system up. Given the continuing structural challenges within the EMU, these periods of muddling through will be accentuated by an acute crisis for which short term responses are found without addressing fundamental governance reform. In the long run, this may well threaten the European integration process if a particularly acute crisis runs out of control or when the long-term imbalances lead to a build-up of political frustration in the countries providing and the countries receiving support.

The role of the Commission

To overcome these issues, the literature suggests that a 3rd party could take the role of arbitrator, acting as an honest broker. The member states (the principles) could delegate some common functions to an independent body (the agent), which acts in the common interest. This could be (and arguably was in the past), a function fulfilled by the Commission. But the member states no longer trust the Commission to act in the common interest, in part because the Commission has become more politicised. There is a fundamental conflict between the political function of the Commission, taking a role in the overall political direction of the EU, and its role as an independent monitoring/assessment agency, regulator and arbitrator in the application of EU law, for example in areas such as competition policy or in the assessment of member states' budgetary policies. With an increasingly 'political Commission', potentially further reinforced by the link to the EP elections made through the Lisbon treaty and the *Spitzenkandidaten* process, maintaining credibility as an independent and objective arbitrator might be severely challenged in the future.

One way to address this would be to outsource some of the functions that call for impartial arbitration or objective advice and recommendations. Independent bodies could be set-up such as, for example, a separate competition authority, as well as bodies to monitor fiscal policies, a statistics agency and a council of wise men and women to provide advice on the economic strategy and position of the EU. Undoubtedly, this would be a longer term process, but thinking about a fundamental reform of the Commission along these lines should start now, including clear provisions to reinforce the political accountability of such bodies.

But the fundamental issue is that, at member state level, many have had enough of 'more Europe' due to the crisis and think that it is now time for 'less Europe'. In many countries, there are also signs of the 'British disease', namely that any further integration is seen as undesirable and that further integration steps are blocked, with the argument that this might raise strong objections in the electorate. This will be a significant challenge for the EU. There are already a number of areas where a process of 'inverse subsidiarity' can be observed. These are areas where member states want to retain control but EU solutions are now needed as it is no longer possible to deal effectively with the issue at national level, and they might relate to energy security or migration, for example. In addition, further integration is also becoming necessary for the eurozone due to a process of 'spill-in', i.e. further integration within a policy area with the aim of avoiding negative consequences, here driven by the necessity to correct the flaws of the EMU (these contrast with positive reasons for integration, such as a wish to move towards a federal Europe or the pull of positive spill-over effects). Increasingly, we will see that what is politically possible diverges further and further from what is required to effectively deal with the challenges the EU faces. Clearly, to have effective decision-making, there first needs to be agreement on what the EU should be doing. At the moment we are nowhere near such agreement.

More government than governance

Ultimately, there is a need for more executive powers at EU level, especially so as to be able to react swiftly to any emerging crisis. In addition, an effective system also needs to have accountability mechanisms. In national systems, this is usually performed by the legislative. But with co-legislators, the Council cannot hold itself to account if it also has an executive role. There is also now a greater role for national parliaments, which can create additional uncertainty: who, in the end, holds the executive to account? The Council, the EP, the national parliaments, or a combination of these?

Currently, most member state governments are unwilling to relinquish control of executive powers in politically highly sensitive areas to the Commission, insisting that the final decision-making power should be retained at national level or, at the very least, in the Council. But there is no effective way in which two bodies can share this kind of executive power. While co-legislation can work due to its sequential nature and the absence of acute time pressure, co-executive power shared by Council and Commission is likely to create uncertainty and delay that can be very costly in a crisis. The only way out is to vest powers in a

supranational body, whether it be the Commission or another construction. There is thus a need to construct a grand political bargain based on the wishes of the population that provides an acceptable deal, including institutional and treaty change. But further far-reaching steps seem highly unlikely at the moment, so at the very least it will take time until the political environment is right. So, what can be done in the meantime, in addition to preparing for such a bargain?

Improving output legitimacy[3]

One short-term measure may be to improve the effectiveness of the EU institutions, especially the Commission, in delivering their policy priorities, thereby improving so-called output legitimacy. But the Commission is not necessarily structured efficiently: a long-standing issue, aggravated by the recent enlargements of the EU, is the number of commissioners. While the EU treaties have provided for a reduction in the number of commissioners to enable the EU to cope with successive enlargements, it has proven to be impossible to get the political agreement for countries to give up the principle of one commissioner (at least) per country. Equally, having 'junior' and 'senior' commissioners, in line with similar arrangements in many national governments, does not seem to be acceptable to many member states, with some of the smaller states worried they would perpetually end up with junior posts.

The number of commissioners increasingly leads to a strong 'silo' mentality, with each member of the College virtually autonomous when it comes to their own portfolio's competences, and where inter-service consultations and infrequent top-down direction from the Commission president is insufficient to break the overall pattern. Eventually this leads to a lack of coherence and focus, and in the worst cases can give rise to uncertainty about the overall direction and may even create outright contradictions. There is, however, a way of potentially overcoming these difficulties. This would be through building on the existing structure: creating clusters of commissioners around vice-presidents.

In previous publications,[4] we have suggested a possible distribution of priorities for vice-presidents and clusters of commissioners to ensure that the structure of the Commission mirrors the overarching challenges of the EU. The new structure of the Juncker Commission does partially reflect these suggestions, with seven vice-presidents covering broad thematic areas without a specific portfolio. However, there is one crucial difference: in an attempt to maintain flexibility (and possibly to assuage the member states' fears that this would create 'junior' commissioners), the clusters of commissioners differ for each broad policy area, with many commissioners contributing to more than one area. In other words, there is no clear cluster structure but a matrix, as well as numerous overlaps between the vice-presidents themselves and between vice-presidents and commissioners, both in terms of portfolio content and in terms of the supporting bureaucracy. At the very least, this will require the clear definition of which commissioner is ultimately responsible for what and who reports to whom at the outset of the Commission, but even so, the structure might well prove ineffective without a clear hierarchy. This new way of working will also require effective coordination between the president and the vice-presidents, guided by a common purpose and vision.

3. The following sections draw on Zuleeg (March 7th 2014).
4. See Zuleeg (September 9th 2014).

A more political Commission

If, in the end, this works, it will improve output legitimacy and, at the same time, will turn the Commission into a more political instrument, with clear-cut political priorities and the ability to better deliver and implement them, which raises fears over the politicisation of the Commission as discussed earlier on.

But politicisation should not be seen as a negative process. For a long time, many convinced Europeans have lamented that the EU is remote from its citizens, that democracy is not functioning as it should at EU level and that there is no engagement with EU policy debates. While current governance/political developments certainly do not answer all the questions posed of EU democracy, at least it is a starting point to get citizens more interested in EU policy decisions.

Even if it were desirable, it seems unlikely that we could go back to a 'golden age' where the Commission does not get involved in politics. The Commission is already highly politicised and, increasingly, the EU needs a Commission able to make executive decisions that can be implemented across the EU. This means a move from governance to government, from a rules-based legalistic system to one driven by political preferences, underpinned by mechanisms of legitimacy and direct accountability.

But to do this, democracy at EU level also needs to be further developed to facilitate engagement. In addition to the existing mechanisms of representative democracy, which are still struggling with low engagement and participation, there is a need to develop a more accessible, informed participatory democracy by utilising new technologies and building bespoke mechanisms for citizens to have input on EU decision-making, such as developing an EU version of 'liquid democracy', where citizens can be involved directly in EU policy. In addition, there needs to be a clear mechanism to hold the Commission to account for its executive/political decisions, a role the EP could increasingly play. Improving democracy at EU level will also require the finding of a solution to deal with the differences between member states, especially the Euro *ins* and *outs*, with a need to find a way of re-invigorating differentiated integration. While progress is certainly possible, in the end, decision-making and accountability at EU level will only be as effective as member states allow it to be.

By and large, the EU could start to introduce some of the changes proposed here in the near future, without major changes to the institutions or the EU treaties. However, the elephant in the room is the question of what member states want the EU to do and how far they are willing to make the necessary changes, especially if they require the further pooling of sovereignty in some areas.

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EMU GOVERNANCE: BETWEEN *DEMOI* AND *KRATOI*

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The so-called euro area crisis has fuelled intense debates on the evolution of the balance between technocratic governance and political accountability in the EU. It is first enlightening to consider the main actors of such a crisis, so as to underline how these debates can lead to very different outcomes according to their starting point.

The European Central Bank has played, and will continue to play, a key role in technocratic governance and in the framework of a precise mandate, both of which are established by the EU treaties. It has been politically accountable at European level, especially through its dialogue with the European Parliament, but there is no way for citizens or their representatives to reject or replace its members.

For its part, the European Council has also taken crucial decisions to cope with the euro area crisis in a very different institutional context: the heads of state and government are accountable to their parliaments and/or the citizens of their countries and, as such, they have illustrated the advantages and limitations of highly political governance. The co-existence of these national accountability mechanisms can indeed explain why it has been so difficult to reach compromises at European level, given the contradictions in the positions backed by the heads of state and government and the majority of the citizens they represent. In this regard, it has to be underlined that, if the European Council has often decided "too little, too late", this is also the consequence of the contradictions expressed by its members, who are all accountable to their national "demos", and is not the consequence of a "democracy deficit".

Last but not least, the creation of the "troika" composed of the IMF, ECB and European Commission members has naturally fuelled a far different story. And it is true that it has combined technocratic governance, blurred responsibilities and extremely weak parliamentary and political accountability. The photos of unknown technocrats in grey suits arriving at the airport to harden conditions and give instructions to national authorities have been perceived as the symbol of a governance which is all the more criticised because the powers it exercises are substantial.

As we shall see, the troika should nevertheless appear not only as a striking symbol, but also as a relative exception in the history of EMU governance.

Considering the specific role of other important actors, especially the European Commission, widens the debate on the balance between technocracy and political accountability. Conversely, such widening of the perspective leads to insistence on the need to put more faces to the political divides that structure the governance of the EMU, both at executive and parliamentary levels, so as to make it more transparent and more accountable to EU citizens.[1] More democracy in EMU governance also means more clarity on its *kratos* and *demos* dimensions: that is what this article is about.[2]

The troika and the "IMF regime": an exception in EMU governance

The euro area crisis is also a "sovereignty crisis", which has led to change in how competences are distributed between the EU and its member states. This crisis has therefore led some of these states to provide assistance to those whose private and public debts had become excessive in exchange for increased EU monitoring of national fiscal and economic policies. In this context, the series of "memoranda of understanding", "packs" and "pacts" seems, however, to have produced a political system based on poorly defined responsibilities, while EU treaties are more traditionally based on the principle of subsidiarity.

The creation of the troika is the most striking element of a general evolution of EMU governance which deserves in-depth analysis to establish the extent to which the recent reforms have limited the scope of national democracies and sovereignties. This means putting up for debate the idea that "Brussels" governs member states without the legitimacy to do so—though this is not generally the case[3]—and trying to more precisely define the various *kratoi* at stake within EMU governance.

Table 1. The way competences are exercised in the EMU

Purpose	Tools	Keyword	European actors	Comparable actors
Bailout	Memorandum of Understanding (MoU)	Condition	Commission / ECB, Council	IMF
Preventing/correcting fiscal excesses and macro-economic imbalances	Stability Pact, TSCG	Sanction	Commission, Council	UN
Monitoring economic and social policies	Europe 2020, Euro + Pact, TSCG	Incitation (political)	Commission, Council	OECD
Promoting structural reforms	Reform financial aid	Incitation (financial)	Commission, Council	World Bank

Source: Yves Bertoncini, António Vitorino, Reforming Europe's governance, op.cit.

With this in mind, it is important to give more detailed analysis to the nature of the competences held by the EU under the new EMU governance regime and compare them with those that other international organisations exercise. This prior clarification is crucial both in order to get recent developments into proper perspective and to make it possible to implement, on a healthy basis, all those adjustments that EMU governance still requires.

If we leave aside the competences exercised in the framework of the banking union, it is possible to classify the relations between the EU and

1. For more developments: Bertoncini and Vitorino (2014).
2. This article is directly inspired by my speech at the seminar «Redesigning EMU governance in light of the Eurozone crisis» organized by CIDOB on 21 November 2014 in Barcelona. I thank the organisers for their invitation and the quality of the debate.
3. For a more detailed discussion of these issues, see Fernandes (2014).

its member states under different political regimes in which national or popular sovereignties are being jeopardised to extremely varying degrees: four different political regimes can be identified that have an extremely variable political impact on national or popular sovereignty (see Table 1):

- The **"IMF regime"**: the sovereignty of the four "countries benefiting from European aid programmes" is conditioned by the fact that representatives of the troika and of the European Council can combine an obligation to achieve results with an obligation concerning the means for achieving those results, demanding specific, major pledges in return for the loans they grant. Other than when a new bail-out is required, it may appear to be possible to extend this European control over the budgetary, economic and social choices made at national level only in the event that all or some of the member states commit to the mutualisation of national debts (eurobills or euro bonds).

- The **"UN regime"**: this regime applies to the monitoring of national budgetary surpluses (rather than national budgets per se) and also rests on member states' pledges not to exceed certain budgetary ceilings (in particular, a deficit standing at over 3% of GDP). If they comply with these ceilings, they are free to act as they please, but if they consistently exceed them then in theory they can be subjected to a coercive approach based on potential financial penalties. In any event, member states have an obligation to achieve a result (i.e. to return below the ceiling) but no obligation as to the means used to achieve that result: it is up to them to define the ways chosen for achieving it and it is their choice whether or not to comply with the EU's detailed recommendations.

- The **"hyper-OECD regime"**: this regime concerns the relationship between the EU and its member states with regard to monitoring national economic and social policies, hence "structural reforms". These relations are based on a combination of political initiatives (recommendations, supervision and mutual pressure) enacted among member states. This political pressure is considerably greater than that brought to bear by the OECD, yet it has no compulsory impact on the member states' domestic political choices. Where structural reforms are concerned, the EU can recommend but it cannot command.

Table 2. The scope and impact of competences exercised within the EMU

Tools	Political scope	Geographical scope	Temporal scope
Memorandum of understanding (MoU)	Definition of national economic and social policies	Greece, Ireland, Portugal, Cyprus	2009-2014 (GR, (IE, PT), 2013-2016 (CY)
Stability & Growth Pact, TSCG	Control of national fiscal excesses and macroeconomic imbalances	EU28, EU25 (except Croatia, UK & Czech Republic)	Since 1997 (SGP), Since 2013 (TSCG)
Europe 2020, Euro + Pact, TSCG	Coordination of national economic and social policies	EU28	Since 2000 (Lisbon Strategy)
Reform aid fund	National structural reforms	Euro area	Post-2014?

Source: Bertoncini and Vitorino, 2014.

- The **"World Bank regime"**: this regime rests on the principle that if the EU grants financial aid to member states that aid must serve to promote structural reforms at a national level. The proposal to set up a new "financial tool for convergence and structural reforms" illustrates this approach, as do the reiterated attempts to enforce macroeconomic conditionality in return for access to European structural funds.

Such a classification shows how different these four political regimes are, including from a geographical and temporal point of view (see Table 2), reminding us that the "IMF regime" and the troika are to come to an end in the near future. It also highlights the fact that, in the absence of clarification regarding the real scope of their competences and powers, the "EMU institutions" will continue to adopt doubly counterproductive positions and recommendations: on the one hand those positions and recommendations will be perceived as being excessively intrusive and thus illegitimate in view of their level of detail, while on the other they will ultimately have no direct, concrete impact on the decisions taken by the member states concerned.

The executive dimension of EMU governance: more faces for more accountability

The crisis in the euro area has led to a strengthening of the European Council, which the Lisbon treaty accords full recognition as an institution. This "crisis government" was rightly criticised when it turned into a tandem ("Merkozy"), the existence of which sanctioned a break with the formal equality that exists among the EU's member states. The negative perception of this tandem has then reinforced the need to have more legitimate and accountable faces at European level to embody the EMU governance: from a *demos* perspective, it is indeed key to rely on bodies and actors able to personify this governance and, more concretely, able to answer the questions raised by citizens and public opinions all over the EU.

In connection with this, aside from the ECB and its management – which has to continue steering the euro area's monetary policy and taking on new functions in the field of banking supervision – the governance of the euro area needs to be consolidated at the presidential and ministerial levels on the basis of the following guidelines (see Table 3 for a global overview).

Regular summits for the euro area

As the name suggests, the "euro area summits" constitute, first and foremost, a place of power that is specifically devoted to the euro area at which the heads of state and government of the area are called upon to decide on the main guidelines to be followed with regard to bailouts of struggling countries and the organisation of the EMU. The principle of such summits were long rejected, especially by the German authorities, on the pretext that they might represent an attempt to place the ECB under the supervision of, or be pressured by, the euro area member states. It was the crisis that hastened their advent in 2008, under the French presidency of the EU. Since then,

they have been granted a stable president (currently Donald Tusk) and "Rules of Procedure" detailing their organisation and functioning.[4] These rules specify that the president of the Commission is an *ex-officio* member of such summits, that the president of the ECB is "invited to participate", that the president of the Eurogroup may be "invited to be present" and that the president of the European Parliament may be "invited to be heard". By virtue of their composition, these summits are therefore expected to meet regularly in order to exercise "leadership" over the key euro area issues by requesting expertise and recommendations from the Council, the Commission and the ECB. With this in mind, and as suggested by the French and German authorities, it would be extremely useful for the euro area summits to rely on the Eurogroup, but also on the ministers of the council of employment and social affairs ministers and those of any other type of council that is likely to provide a vision that is not limited to economic and financial issues alone.

A Eurogroup with a full-time president

Established in 1997, the regular meeting of finance ministers of the euro area countries, or the Eurogroup, constitutes the natural ministerial component of the euro area government. The euro area crisis has nevertheless highlighted the democratic shortcomings of such a body in terms of visibility and accountability; the conditions governing the adoption of the Cyprus bailout, of which almost no Eurogroup member seemed openly to admit ownership, remains, from this point of view, a particularly catastrophic counterexample. In this context, the swift appointment of a full-time president of the Eurogroup would be welcome in terms of both effectiveness and legitimacy.

The public good that the euro represents should actually be supported and embodied continuously rather than sporadically. This dual mission should be the responsibility of the president, not only so that he can ensure the follow-up of decisions made within the EMU framework, but also to be accountable to member states and members of parliament. In the long term, the post of Eurogroup president could be combined with that of the European Commissioner for Economic and Monetary Affairs, as appropriate, according to the current model in the field of the Common Foreign and Security Policy (CFSP) (the EMU and the CFSP being precisely two areas in which the combination of national sovereignty and the European approach is required).

The Commission's hybrid role

The Commission should also play a key political role in euro area governance, conducting missions that are both "presidential" and "ministerial".

Missions should be "presidential" when they involve contributing to the work of euro area summits on the basis of analyses and proposals prepared by the Commission's services, then debated and endorsed by the College of Commissioners so that they fully convey the cross-sectoral added-value of the institution.

4. See Council of the European Union, "Rules for the organisation of the proceedings of Euro summits", March 2013.

"Ministerial" missions come into play when it comes to drawing up legislative and fiscal initiatives required for the smooth running and organisation of the euro area. It goes without saying that the full involvement of the College will also help strengthen the political weight of the Commission's contribution within the euro area government, while the influence of the Commissioner for Economic and Monetary Affairs will be structurally more limited in comparison to the Eurogroup president if he too often appears to be acting alone. The College of Commissioners, which brings together members of varied backgrounds and responsibilities, should also ensure full supervision of its services so that its positions and contributions can enhance its political legitimacy and effectiveness relative to those made by the Eurogroup.

Table 3. Completing the institutional architecture for the euro area

	The executive governance of the euro area
Presidency level	Regular euro area summits with permanent president and input from the president of the Commission
Ministerial level	Eurogroup with full time president and input from the Commission
	The euro area's parliamentary dimension
European Parliament	Subcommittee for the euro area (open to all MEPs, up to a maximum of 60 members)
National parliaments - European level	Interparliamentary conference for the EMU (open to representatives of the 25 national parliaments that have ratified the TSCG, up to a maximum of 150). Participation of MEPs up to a maximum of 30.
National parliaments - National level	Strengthening ex ante and ex post control of their government when deliberating and voting on euro area issues.
	Stronger services for the euro area*
Bail out	ESM, then expanded EFSM / Commission, Eurogroup, ECB «Trio» (instead of troika).
Budget supervision	Commission – Eurogroup Secretariat – European Treasury
Economic Coordination	Economic and Financial Committee - Euro area working group

NB: already put in place, **yet to be implemented**.
* For more precision on the "stronger services for the euro area", see Bertoncini, July 2013.
Source: Bertoncini and Vitorino, 2014.

Strengthening the euro area's parliamentary dimension: more familiar faces for the governance of the EMU

From a citizen's point of view, deepening the democratic dimension of EMU governance must also lead to the provision of more powers and more visibility to his/her direct representatives, i.e. the members of parliaments. The euro area crisis has indeed confirmed the need for heightened debate between citizens' direct representatives, which must not be limited to the occasional "solemn rituals" that the European Council meetings and euro area summits are today. The crisis has stimulated reflection on the way to better include European as well as national members of parliament in such debates to the point of creating major tensions between these two categories of citizens' representatives.

It is therefore vital to highlight the fact that the central issue is to organise more democratic support for the progress that has recently been made possible in EMU governance and to prevent the weakening of the democratic dimension of the EU and the role of the European Parliament. It is necessary to bridge certain gaps in the European "democracy deficit", not to redistribute a limited number of parliamentary prerogatives: the objective is to reinforce "cross legitimacy" at parliamentary level, as underlined by Ulrike Guérot.[5] In other terms, all EMU parliaments are, in reality, confronted with a positive agenda that needs to be implemented at several levels. Independent of the necessary strengthening of the supervisory activities of national parliaments in relation to their own governments, two complementary initiatives should also be encouraged at European level so as to strengthen the euro area's parliamentary dimension.

More national parliamentary control over governments

National parliaments have, as usual, ratified any amendment made to the TEU, the treaty establishing the ESM and the TSCG – the two last being approved by referendum only in Ireland. This weighty intervention on the part of the primary organs of representative democracy at national level highlights the full legitimacy of those elected by the people to take decisions having a structural impact on the functioning of the EMU. Yet it is at odds with the far more heterogeneous involvement of those parliaments in the regular monitoring of the guidelines adopted by their heads of state and government, or even by their government, at European level (see Table 4).

This parliamentary oversight is extremely specific in such countries as Denmark and Germany, but far less structured in, for example, Luxembourg and Romania.[6] Angela Merkel has regularly had to report to the Bundestag, whose decisions have often been awaited with a certain anxiety, whereas the French president is not even legally authorised to appear before the chambers of the French parliament, where he must delegate his presence to the prime minister or, more often than not, to the minister for European affairs. This variety is the product of constitutional choices and political ethics that are themselves extremely variable from one member state to the next. Yet such a situation is detrimental to the governance of both the EMU and the EU as a whole, because it is within the member states themselves that the «democracy deficit» associated with this governance is largest, given that numerous governments can take decisions which are of vital importance at European level without their action coming under any kind of scrutiny or being aired in any kind of in-depth public debate. In connection to this, it is a good thing that article 13 of the TSCG calls for a strengthening of national parliaments at the European level, but it would be just as useful if certain institutional and legal adjustments were to be made within those member states whose parliaments play an insufficiently strong role, in order to strengthen the democratic aspects of the EMU governance.[7]

5. For more precision on this issue, see: Menghi, (30 October 2014).
6. On these issues, see Rozenberg, et al. (January 2013).
7. On this issue, see also Stratulat, et al. (January 2014).

Table 4. Parliamentary monitoring of European Council and euro area summits				
Ex-ante / **Ex-post**	**Reduced involvement**	Committee	Plenary	Involvement both in committees and plenary
Reduced involvement	**Limited control model** Hungary, Luxemburg, Romania	**"Europe as usual"** Czech Republic, Estonia, Italy, Latvia, Poland, Slovakia	Netherlands	
Committee	Cyprus	**Expert model** Belgium, Finland, Lithuania, Slovenia	France	**Policy maker** Germany
Plenary	**Government Accountability** Bulgaria, Malta, Spain, UK	Austria, Sweden	**Public forum** Ireland	
Involvement both in committees and plenary	Greece	Portugal		**Full europeanisation** Denmark

Explanation: Reduced involvement = fewer than 3 meetings at European affairs committees (EACs) and fewer than 3 sessions in plenary from March 2011 to March 2012. Committee = 3 or more meetings at EACs and fewer than 3 sessions in plenary. Plenary = fewer than 3 meetings at EACs and 3 or more sessions in plenary. Involvement in both = 3 or more meetings at EACs and 3 or more sessions in plenary.
Source: Rozenberg, et al. (January 2013).

A "euro area subcommittee" in the European Parliament

A "euro area subcommittee" should first of all be established within the European Parliament, which would simply require the modification of its rules of procedure. Such subcommittees already exist in fields where the EU does not necessarily have more powers than in euro area governance, such as human rights or defence: it is therefore logical that a subcommittee of the same type could be established, for both functional and political reasons (the euro is a public good that is sufficiently valuable to merit a specific parliamentary group).

This subcommittee should principally be composed of European Parliament members sitting on the Economic and Monetary Affairs, Employment and Social Affairs and Budgets committees. For legal, political and philosophical reasons, this subcommittee should not be reserved for members of parliament elected within the euro area countries alone, but should be open to all members of parliament wishing to join it, up to a limit of 60 members, for legal (TEU articles 10.2 and 14.4), political (not to re-establish borders within the EP) and philosophical (all EU countries are concerned by the EMU) reasons.

The newly-elected MEPs did not take the decision to establish such a euro area subcommittee when they took office in summer 2014. But they could still do it in the near future via a simple modification of the EP internal rules of procedures.

A fully-fledged inter-parliamentary conference for the EMU

Better involvement of national parliament members in EMU governance should also be organised on the basis of article 13 of the TSCG, which provides for the establishment of a "conference of representatives of the relevant committees" of the national parliaments and of the European Parliament in order to discuss economic and fiscal issues. This does not mean creating a new European "institution", but rather providing the opportunity for national and European Parliament members to meet and discuss issues related to the EMU, in order to increase their level of involvement and mutual understanding.

The organisation of such a conference would be useful on two counts: it would allow greater involvement of national parliament members at EMU level, which would be helpful given their role in adopting euro area bailout plans and in decisions related to national fiscal and economic choices; and it would bring together representatives from all the specialised committees linked to EMU governance, in particular the Economic and Financial Affairs Committee, not just the European Affairs Committee. The mobilisation of six members per country would guarantee good representation of the committees and the political groups, up to a limit of 150 members. The 30 full member of the euro area committee of the European Parliament would also participate in the work of this conference. In short, this conference would play a role similar to that played by the COSAC, but in the sphere of the EMU, and should be both a forum for discussion and an influential stakeholder. This objective will naturally be easier to achieve if the conference has the necessary resources and publicity to strengthen and maintain the motivation of the national parliament members concerned.

From this perspective, the agreement reached by the parliaments on the occasion of their 2013 and 2014 meetings has shown the need for a much stronger organisation: it is because this conference will adopt genuine "rules of procedure"– describing the number of its members and the nature of its activities – that it will be able to play the useful role it has been given on the basis of a functional distribution of tasks between the parliaments.

Sharing tasks out among parliaments in a functional way

The parallel establishment of two parliamentary bodies dedicated to the euro area would only enhance the democratic dimension of EMU governance as it would be based on a functional (not a rigid or exclusive) distribution of tasks.[8] In addition to its contribution to the European Parliament's exercise of legislative powers, the euro area subcommittee could thus ensure comprehensive and continuous supervision of EMU positions and decisions and adopt resolutions on the decisions made by the executive authorities. For its part, the EMU inter-parliamentary conference could meet in the spring and autumn to adopt resolutions on national economic and fiscal strategies. These two bodies could also conduct regular hearings with euro area leaders. The euro area subcommittee would focus on European leaders while the EMU inter-parliamentary conference would put questions to national and intergovernmental leaders. Joint hearings could be conducted on an

8. For more detailed analysis and proposals on this subject, see Bertoncini (April 2013).

ad hoc basis, in particular for presidents of euro area summits and the Eurogroup.

The follow-up of decisions connected to the euro area's "fiscal capacities" should also be shared. For example, the monitoring of the use of bailout funds should be conducted by the EMU inter-parliamentary conference for the ESM, and by the euro area subcommittee for the EFSM. The supervision of European funds allocated to the implementation of national structural reforms or those from a possible "cyclical adjustment fund" would be attributed in relation to the origin of these funds: the inter-parliamentary conference for national funds, the euro area subcommittee for Europeanised funds, including the insistence on enhanced cooperation.

The creation of two parliamentary bodies dedicated to EMU governance could finally make it possible to think about the possible organisation of sharing mechanisms concerning the issuing of national debt (redemption funds, eurobills, euro bonds, etc.). In the short term, the EMU inter-parliamentary conference would undoubtedly be the ideal forum for discussing these issues, as today debts are issued at national level to finance budgets voted upon by national parliaments. The European Parliament euro area subcommittee should also explore the possibility of issuing common debt, in accordance with the terms of the agreement reached with the adoption of the two-pack. It is particularly important for it to be involved if euro bonds are issued to finance EU expenditure in the area of investment in trans-European networks, for example.

Conclusion

Citizens in the euro area's member countries have now taken on board a greater awareness of the specific rights and duties involved in membership of the monetary union. They have expressed contradictory concerns and resistances regarding these rights and duties: some of them consider that belonging to the euro area has brought excessive stringency, while others have shown their reluctance towards the solidarity mechanisms recently put in place. All in all, a majority of the citizens in each member country has confirmed its wish to remain in the euro area.

In this context, it is essential to underline that the euro area crisis has already generated a certain amount of progress in a democratic direction. Yet the process needs to be completed in order to ensure the legitimacy and effectiveness of the EMU's governance on the basis of the complementary guidelines set out in this article.

To be efficient, this kind of democratic process has to focus both on the *demos* and *kratos* dimensions of EMU governance, and even on its several *demoi* and *kratoi* dimensions: there is indeed neither a single *demos* nor a single *kratos* in the EMU. It is therefore through the combination of democratic actions to address the multi-dimensional issues at stake, including analytical pedagogy, institutional reforms and political accountability that the national and European actors will be able to restore and deepen the legitimacy and effectiveness of EMU governance, as well as the functioning of the EU in general.

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Europe's "Catch-22"

European democracy is the buzzword for Europe's current situation. Requests for a different, better and more democratic EU dominated the 2014 European Parliament elections throughout the continent. This points to a deeply-felt malaise being voiced by European citizens about the European governance structures, which they perceive as profoundly technocratic.

The current "public-sphere" discussions about Europe do not, however, seem to correspond to these requests. The European governance system at large seems not to envisage profound changes such as treaty reform or constitutional changes, which would provide hope for more or less fundamental change towards more democracy, legitimacy and participation in the European system. The system currently shows itself to be reform-averse. By contrast, in many countries, especially Germany, the general assessment seems to be that the euro crisis is over, that growth will return, that the European south is recovering from austerity and that, after the shocks of the crisis years, normality is the way forward and no political focus is being placed on moving the system towards deep changes to provide more input-legitimacy. National political elites seem to be too afraid of increasingly raised populist voices and systemic inertia is spreading.

This narrative of Europe being back to normality can be challenged.[1] The assumption that the economic, social and political crisis is over can be put into question. Countries like Spain, Greece, and even Italy and France seem not to have touched bottom either in economic or political terms, quite the opposite. The regional elections in France in March 2015 displayed a frightening increase in the populist vote;[2] forecasts predict that in the Spanish elections of September 2015, the current government will be outvoted and that the protest party Podemos could receive close to 30%. The Greek economy may be slowly recovering - Greece had a budgetary surplus before debt servicing in 2014 of 0.6% of GDP. Hence the Greek debt crisis is unsolved and latent and the political situation remains messy, to say the least.[3] So in general terms, Italy, Spain and France remain in bad shape, which even the OECD is admitting.[4] Not only is growth not on the horizon, the signs are that an 'economic storm' may well return. Recent

1. See Philippe Legrain, *The Eurozone's false recovery*, 15th April 2015, in: www.socialeurope.eu
2. The Front National was the second party behind the UMP, with 25%. This "average result", however, hides the real penetration of the FN, which reached the second round in half of the cantons and in many it received 35% or more of the vote.
3. This text was drafted and delivered before the newest outburst of the Greek crisis after the Greek election of January 2015, which triggered hot and on-going debate about a possible "Grexit"/ "Graccident", which confirms the thesis that the narrative of post-crisis "normality" can be challenged.
4. See: http://www.oecd.org/eco/economicoutlook.htm

moves by the ECB (Collignon, 2014) to lower interest rates again in early December 2014 send rather disturbing signals with regard to market confidence and carry the potential to divide the eurozone again. After all, the euro system failed to do two essential things during the crisis: provide monetary and fiscal backstops for the eurozone as a whole. Despite some progress on banking union, this remains unfinished business because of a lack of capability and political will. In other words, within the eurozone every country is still wearing its own raincoat but a common fiscal and monetary roof has yet to be constructed, even if the ESM is in place and the EU has moved on with the single supervision and single resolution mechanisms in banking union. There is still no common deposit scheme, meaning that the vicious circle of bank debt and sovereign debt that the European Council envisaged dealing with at its meeting as far back as June 2012 has still to be resolved. [5] In other words, the final arrangement that debtor and creditor countries reach regarding the costs of the crisis remains to be seen.

The question is thus whether the EU, or more precisely the eurozone, has wasted a crisis and is de facto already in a state of disintegration, economically, as well as politically.[6] Measured against the report of the four EU presidents published on June 26th, 2012, "Towards a Genuine Monetary and Economic Union",[7] one can say that none of the four building blocks mentioned in this paper – economic, budgetary, fiscal and political union – have been fully achieved, especially not the political part, which will be the key topic of this paper.

In the meantime, several policy papers have been written that advocate deeper economic, fiscal and political integration, first and foremost of the eurozone. Most important here are the papers of the so-called "Glienicker Gruppe"[8] and the corresponding French paper written by the "Groupe Eiffel".[9] Despite some differences, the two papers focus on an institutional deepening of the eurozone first.[10] They argue that systemic change within the EU-28 is barely possible, meaning that, beyond the treaties, some sort of institutional/constitutional steps for the eurozone should be envisaged in order to allow progress. This points to a significant "Catch-22" situation in which the current EU system finds itself: the system cannot reform, but neither can it provide the solutions euro-governance needs in order to function. There is, therefore, systemic inertia, if not deadlock, which petrifies current economic output underperformance, which then fuels Euroscepticism and populism in the whole eurozone area; it is a vicious circle. The EU is thus in a dramatic delivery gap on both the input (democratic legitimacy) *and* the output (economic performance) sides.

Tackling the input-legitimacy question

With the euro system underperforming, not securing a satisfying social and economic output for European citizens, European debate has shifted to vast requests for more input legitimacy, meaning more *democratic* decisions: people want to have a say in the policies they are suffering under. In the academic literature, the complaint about Europe's democratic deficit is widespread (Nikolaidis and Youngs, 2014), pointing, above all, to the need to give national parliaments a bigger role in European decision- and policymaking. The normative request is to overcome the democratic deficit through transnational parliamentary cooperation.

5. See: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131388.pdf
6. Annegret Eppler/Henrik Scheller (2013) (Hrsg.) *Zur Konzeptionalisierung europäischer Desintegration. Zug- und Gegenkräfte im europäischen Integrationsprozess*, Baden-Baden: Nomos Verlagsgesellschaft.
7. See: http://ec.europa.eu/economy_finance/crisis/documents/131201_en.pdf
8. See http://www.glienickergruppe.eu/
9. See http://www.groupe-eiffel.eu/
10. The reflection of this paper will also focus on European Union developments based on the assumption that if the EU deeply integrates, most current EU-28 would seek to join the euro very quickly, notably Poland, Denmark and Sweden etc. The 'only' EU countries remaining outside the euro then would most likely be the UK (due to the very specific discussion and political landscape in this country), and the south-eastern European countries Hungary, Bulgaria, Romania and Croatia, because of their great economic divergence. Euro-accession over time should, however, be aimed at, through a contractual build-in strategy.

As much as this is normatively fully understandable, this has led, however, to a problematic discourse distortion. Much of the debate in Europe is now about whether or not national parliaments should have more rights and/ or control in European policymaking, or whether the solution is, on the contrary, to increase the oversight – and the legislative rights – of the European Parliament. As a result, Europe sees itself being pulled into a problematic discourse, where national parliaments are played off against the EP. This leads to an unhealthy dichotomy of "more or less" Europe, with the "less" camp supporting an increase of the role of national parliaments and the "more" camp supporting the conversion of the EP into a more fully-fledged legislative body (which it is it not yet, as it has no right of *legal* initiative). This *vertical* rather than *horizontal* framing of the discussion tends to overlook the fact that playing national vs. European parliaments weakens the legislative body as a whole, to the detriment of European democracy.

It would therefore be desirable to succeed in (re-) framing the discussion in such a way that the real question would be how to build a strong legislative body – in clear distinction to a (future) executive body – of the EU, combining the national parliaments with the EP in something that could be called "*crossed legitimacy*." This would eventually allow the shift of the EU polity to a system based on the division of power, following Montesquieu's principle, as requested already in the Westerwelle Report on the "Future of Europe" by European foreign ministers in September 2012.[11] The vertical dichotomy ("more or less Europe") insinuates that the question or problem of Europe is "more or less integration", and that "less", meaning returning more rights to national parliaments, would be the better option, given people's resentments of the EU. Yet if one presumes that the euro is here to stay and rejects the scenarios of euro-unravelling, the degree of (*vertical)* integration is no longer the question: Europe is monetarily completely and economically very nearly completely integrated. European integration is yesterday's buzz-word; European democracy tomorrow's. The real problem is the (*horizontal)* design of European democracy, or, in different words, how to make the political and social space of the eurozone congruent with its integrated monetary and economic reality. The question is no longer about the degree of European integration, but the quality of European democracy. The real question is whether large-scale European democracy can be designed in a downright post-national setting. And if so, how?

Transnational, not supranational

The sheer semantic shift from putting democracy and not integration at the centre of the European focus is not a trivial exercise. It points to the nascent development of a *republican* concept of Europe, which seems to be currently undergoing a flush of growth in academic literature (Thiel, 2012; Nowrot 2014), and where the duality of the current EU as both union of states and union of citizens is tilted towards a more citizen-based concept to the detriment of the strand of legitimacy provided by the states. This movement seems currently to be central to the theoretical discourse taking place in international political theory (Habermas, 2014). The core idea behind it is that – going back to Jean Bodin,[12] and, more recently, Hans Kelsen, a twentieth-century Austrian constitutional lawyer – sovereignty is an individual rather than collective concept of the

11. See: http://www.auswaertiges-amt.de/EN/Europa/Aktuell/120918-Zukunftsgruppe_Warschau_node.html

12. The very origins of the notion of sovereignty: Jean Bodin, *Les six Livres de la République*, Paris, 1576.

transfer of powers to a political entity (Brunkhorst, 2007). The question of whether or not there is a European *demos*, however dominant currently in public discourse on the democratic validity of the EU, as pushed forward mainly by the German constitutional court, is thus a futile question. The transfer of sovereignty is not bound by a collective (people's) decision, but can be deconstructed to the individual. The question is thus not whether the EU has a *demos* (or *demoi* (Nikolaidis, 2013), but whether European citizens in their double function as both citizens of a state and citizens of the EU can constitute a European polity (Habermas, 2014). The German court, denying a common European *demos*, comes to the conclusion that the EP and therefore the whole EU does not fulfil the criteria of a fully-fledged democracy.[13] Hence, if sovereignty can be deconstructed and attributed to citizens rather than people (encompassed in state boundaries), this opens a theoretical gate for a transnational setting for a future European Union – decoupling the concept of democracy from *one* people/ state – and thus overcoming state boundaries and state-bound concepts of sovereignty, when it comes to the 'sovereign act' of rendering political power to a newly-designed democratic European *polity*. In other words, it opens the way to the concept of an equal European citizenship and thus a *republican* emancipation of Europe (Besson, 2009). On this basis, a couple of concrete policy outlines for the future development of a Euro-Union[14], such as the same electoral voting procedures for the EP (not determined by national procedures); or the same modus of taxation; or the same eligibility for social rights for all EU citizens, could be claimed, as all (modern) political communities must be based on the fundamental principle of political equality of their citizens.

This would also pave the way for a different parliamentary set-up of the Euro-Union, and lay the basis for (re-) designing first the eurozone and eventually the European Union of 28 as a fully-fledged democracy, instead of the current *sui generis* institutional trilogy logic, where the 'political' game is played between the EP, the Council and the Commission, with no distinct legislative or executive body. The euro as an 'orphan currency' - to use the expression coined by Jean Pisani-Ferry[15]- would finally be embedded in a European democracy. *Euroland* would have a democratic house.

Moving from a sovereign-state concept towards a citizen-based concept of European sovereignty would also allow the current discussion between debtor and creditor countries within the eurozone to be framed not as a question of interstate solidarity but as a political question of redistribution – equally and transnationally among all European citizens of the Euro-Union.

Obviously, this would require a (re-) design of European parliamentarianism in the sense that liability and accountability would need to be brought to the same level: if debt mutualisation – meaning a joint monetary[16] and fiscal[17] backstop, one way or the other, or the *de facto* creation of a proper Euro-Union budget[18] - is a prerequisite for the sound survival of the euro then the principle of "*no taxation without representation*" must be brought to the European level. Indeed, it was (or is) one of the biggest flaws of the current Euro-governance system that, while the ESM is a Euro-wide rescue scheme, it was to a large extent the parliament of *one* country (the German Bundestag) that decided

13. See: http://www.bpb.de/politik/hintergrund-aktuell/69361/urteil-zum-vertrag-von-lissabon-30-06-2009

14. What should be understood is deeper political, budgetary, fiscal and social integration of the eurozone first, and opening up for other countries to join, e.g. Poland, etc.

15. *La monnaie orpheline*, in: *Le Monde,* 26th May 2008.

16. E.g. euro bonds or anything that would turn the ECB into a 'Lender of last resort'.

17. e.g. a European Unemployment Scheme, as proposed by former EU Commissioner Laszo Andor in August 2014 and since then widely discussed in the policy community: http://www.guntramwolff.net/wp-content/uploads/2015/02/BRUEGEL_European_Unemployment_Scheme_12.07.2014-Final.pdf

18. Going beyond the current 0.9% to at least 3%, or better, 7-10% of the EU's GDP; see e.g. the proposal published by the French Ministry of Finance: http://www.tresor.economie.gouv.fr/8197_tresor-eco-n-120-un-budget-pour-la-zone-euro

on its existence, its scope and its engagement in the various Greek bail-outs. The very fact that the Bundestag took decisions, which affected most eurozone citizens directly without these citizens having a voice in the German polity is at the core of the European democracy deficit (Somek, 2013). In other words, it is the non-congruency between policy and polity. If the liability is common, which means that fiscal solidarity is extended beyond state borders, then accountability must be exerted in common too. This would mean, on the one hand, giving the full right of legislative initiative to a new Euro-Union parliament,[19] and, in addition, conceiving a newly-designed European parliamentarianism, leading to a bicameral system. The question would then be which body becomes the "second chamber": the (existing) European Council as representation of the 'states'; or a body composed of national parliaments, emerging from COSAC and leading to a new inter-parliamentary assembly.[20] The question to answer would then be which of the two chambers should be *pro rata* in order to correspond to *'one man, one vote'*, and which of the chambers would be proportional. Today, the EP and the European Council both have a proportional structure with a digressive scheme for the EP and weighted votes in the European Council. Yet removing the proportionality factor from the EP would obviously lead to almost no representation of smaller countries such as Malta or Luxembourg.

How do we get there?

Even if the normative request for such a scenario can easily be argued, the reality looks different. The EU is in deep inertia and nearly unable to reform. Worse, national parliamentarians, while lamenting loudly about their lack of ownership in European decision-making and their lack of control are all eager to engage in profoundly redesigning European democracy.[21] At best, national parliaments require better scrutiny of European decision-making, but not a binding compact. Discussions about how to proceed with the articulation of article 13 of the Lisbon treaty, enhancing transnational parliamentarian cooperation and scrutiny, especially in the field of European monetary and economic policy, seem to have been deadlocked since the Vilnius meeting of national parliaments in February 2014, or, at least, national MPs are showing little enthusiasm. The Lisbon treaty will thus probably not alter the current – unsatisfactory – status. In addition, COSAC is either barely working, or it is working below a public radar screen without much political impact or salience. Questions remain over whether specific national parliamentary committees – say fiscal or budgetary commissions – will enhance transnational cooperation and whether entire national parliaments and MPs will find means of closer cooperation, taking European questions out of the European Affairs Committees, which for now dominate European business at national levels in more or less all EU countries.

Beyond European post-democracy

The outlined scenario would obviously be a way to move first the Euro-Union and ultimately the European Union out of its technocratic structure and enhance its input-legitimacy, providing a *different*, better and more direct transmission belt between citizens' votes and European decision-making, thereby increasing European legitimacy. One of the big-

19. As requested by both the Glienicker and Eiffel groups, op. cit.

20. Recent academic literature on this new inter-parliamentary assembly is flourishing, see e.g. Jürgen Neyer: *Empowering the sovereign national parliaments in European Union monetary and fiscal policies*: https://www.academia.edu/11544044/Empowering_the_Sovereign_National_Parliaments_in_European_Union_Monetary_and_Financial_Policy?login=ulrikeguerot@gmail.com&email_was_taken=true

21. cf. Trilogy-Project of the "European Democracy Lab", Berlin: "National Parliaments and European Democracy", (2014): http://ulrikeguerot.eu/de/content/european-democracy-lab

gest flaws of today's structure is that the current techno-structure[22] has no built-in correctives: there is no real opposition in the European system or much reversibility of policy decisions. Whoever wants to oppose the current European policy (austerity), needs to be against the European polity and reject the system itself. This is precisely what fuels European populism these days: the quest for a *different* Europe stems from there.

Policy conclusions

A couple of concrete policy conclusions, or at least how to reframe the European discourse, can be drawn from this:

1) **Step out of the "less/more Europe" dichotomy**: the wrong framing of discussions produces the wrong results. If one accepts that the euro is here to stay, then the question is no longer "less or more" Europe as it is often framed. European integration is yesterday's buzzword; European democracy is tomorrow's. The problem is not 'more or less' European integration. The problem is that the eurozone is monetarily fully and economically deeply integrated, but has no real democracy. For the euro is an orphan currency: a transnational currency without transnational democracy. European citizens do not perceive Europe as intuitively democratic because the so-called *sui generis* structure of the EU's triangular setup – where most political energy is spent on institutional fights between the EP, the Council and the Commission – barely allows political opposition, let alone the reversibility of policy choices. In other words: you can vote all you want but you'll get the same Europe! This is what Colin Crouch called "post-democracy" (Crouch 2004) and what Jürgen Habermas calls "European executive federalism" ("Europäischer Exekutiv-Föderalismus"). If you are against current European policies, you need to be against the EU-system as such. There is no discursive space for 'positive integration' or those who want Europe, but different policies. Whoever wants a political turnaround needs to be against the system. This, in essence, is what fuels the current success of the populists – left and right – because politics is about options.

2) **Care for input, not output legitimacy**: recent figures (Michailidou et al., 2014) show that during the EU elections, 58% of European citizens were Eurosceptic, and, when asked why, the vast majority said it was because of a lack of democracy, or gave no justification at all. Lack of economic prosperity ranked only fourth on a list of seven. And yet the current EU system rhetoric is still driven by providing output legitimacy: if only growth returns, people will accept the EU again, so a popular argument goes. Yet, time has come to realise that those days are gone. Europe will not see the growth rates of 3% any time soon that would reduce (youth) unemployment in a quick and tangible way. In addition, Thomas Piketty (2014) tells us that growth alone is not enough, if it is not followed by redistribution. All this is to say that basing Europe on out-put is no longer enough.

3) **Shift from state legitimacy to citizen legitimacy**: flicking through political science literature and articles on international political thought, there is an interesting trend to observe, which is boosting the opposition of citizen legitimacy and state legitimacy in the European system. In essence, this leads to rethinking the EU's duality between the union

22. See Jürgen Habermas' most recent book: *The Lure of Technocracy*, London: Wiley 2015.

of citizens and the union of states – and thus to putting into question the asymmetric power position of the European Council (or the countries that dominate the Council, for which read: Germany). The revaluation or upgrading of citizens' legitimacy input in legal theory may pave the way for precisely this to happen in the real world. If Germany is a tipping point country for European reform, then (for those who read German) the current intellectual dispute on deliberative democracy between Jürgen Habermas (and his scholars)[23] and Dieter Grimm (2014), a former member of the German constitutional court, is non-trivial. Habermas has removed the state as legitimacy provider in Europe and speaks now of the double legitimacy of citizens, as citizens of Europe *and* citizens of *their* state. Grimm argues that citizen legitimacy cannot work in Europe. Changing and ultimately reforming Europe is first about winning the theoretical thought game. Germany can only go as far with European reform as its legal thinkers allow. In essence, Habermas is de facto preparing the intellectual community for the *republicanisation* or republican emancipation of Europe and thus for a post-national European polity, disentangling European democracy from the nation-state as its constitutive carrier.

4) **Design deliberative democracy in the European arena**: this is certainly not a trivial exercise. Europe has already done a lot in recent years for a deliberative infusion of its governance system, most prominently the citizens' initiatives as a new, democratic part of the EU's significant portfolio of modes of governance, thereby trying to transpose direct democratic instruments onto the supranational arena. Hence most of the empirical literature (Friedrich, 2015) that has sought to gauge its democratic potential has come to rather sceptical conclusions, stating that deliberative processes fall short of expectations of inclusiveness and mutual-learning processes, and that, obviously, language is a huge barrier to transnational deliberation. The next tasks are to further explore how "crossed legitimacy" between national parliaments and the EP could be improved by: elaborating on article 13 of the Lisbon treaty; preparing for a unified election mode for the next EP elections in 2019 for all EU citizens, e.g. aiming for transnational lists; and insisting that the EP should get the right of legislative initiative. All these are concrete steps for improving the means of deliberative and participatory democracy in Europe.

5) **Trust European citizens more than their national policy elites:** one of the most problematic discourse distortions is the fact that national political elites seem forced to cater to the sirens of populist voices, whereas recent empirical social science data shows that a large plurality of European citizens has already accepted the principle of civic European identity (Jürgen and Lengsfeld, 2013), and thus the idea of European citizenship and equality beyond a national paradigm. In other words: European citizens seem to accept transnational European solidarity more than their national elites think they do. This opens up a political highway for u-turning away from discussions about 'austerity policies' and towards discussions on euroland-wide distribution of the aggregated gains of the eurozone; and eventually on a European minimum wage, a European unemployment insurance or a European basic income, at least for the eurozone. In short: European citizens seem to be ahead of their national elites. '*Horizontal Europeanisation'* is in the making![24] This is an interesting finding, especially with respect to the - reluctant -

23. Jürgen Habermas, op.cit.

24. Horizontal Europeanization,"*Die Europäisierung der Gesellschaften Europas: Zwischen nationalstaatlicher und globaler Vergesellschaftung*", Ad Hoc Gruppe beim 27. Kongress der Deutschen Gesellschaft für Soziologie, Trier, 2014.

German discussion about a 'transfer union'. Looking at this data may provide the leeway for reversing the currently distorted discussion about a 'transfer union', given the fact that the German narration of 'solidarity overstretch' does not match with real figures: Germany is not a financial 'victim' of the various Greek bailouts, but has benefitted from both euro-making and even the euro crisis in the first place (Schieder, 2014).

6) **Be serious:** what Europe, especially the increasingly organised anti-establishment youth in Europe (Della Porta, 2009) is waiting for is a 'performative speech act', which runs: "we are really all one". So far the European policy system has not said this: it has distanced itself ever more from the constituted principle of 'ever closer union', especially when it comes to money and debt. The euro crisis has divided Europe into sinners and virtuous, creditors and debtors. It is this dishonesty that has produced the awful credibility gap in Europe. The Erasmus youth finally wants to get what they have been told for twenty years, what they have been educated in and what they have adapted their lives to: European transnationalism! This means portability of social rights, equal European citizenship, one democracy, one government. This generational dynamics of the European debate is often not mirrored in the official rhetoric. The challenge *and* the chance to win the hearts of the next generation for Europe and to not lose Europe to the populists is to combine the European idea with a progressive, democratic agenda beyond neo-liberal technocracy. This is essentially the task of the European left, if it isn't everyone's.

7) For sure, the new '**politicisation**', through methods such as the "*Spitzenkandidaten*" EP race, runs the risk of polarising the debate. But it also holds the promise of a new citizens' mobilisation (Rauh and Zürn, 2014). In this respect, the social sciences seem to suggest that, if the European system is envisaging treaty reform sometime soon, engaging citizens, all risks included, might be the best idea. Rather than going for a new convention, a *Constituante,* composed not of delegations from nation states, but of Europe-wide elected citizens, might then be an innovative solution to look for, moving the authority over the integration process away from the states.

Conclusion

The new European hypertext must be written bottom-up in order to move Europe out of its technocratic structure. Europe has the historical duty to experiment with some more radical democracy concepts, which are in the air of the time. The internet and its impact on representative democracy, the formula of "liquid democracy" brought up by the pirates, the concepts of post-party and participatory democracy are all out there and waiting to be absorbed by a European Union which takes its citizens seriously.

This is obviously a risky exercise. However, social sciences tells us that 'civic identity' seems to be an accepted principle among European citizens; and the political space for moving closer to principles such as equal European citizenship and political equality is there, if only a political party had the ambition to occupy this political space. Cautiously, one can say that the cultural basis for a transnational European democracy among European citizens is in place.

For example, some 70% of Europeans and even 58% of Germans declare themselves in favour of a European minimum wage (Gerhards and Lengfeld, 2013). The European social fabric seems therefore to be proving to be more resilient than is often expected by national elites (Heidenreich, 2014). The discursive structure among citizens is primarily no longer along national lines – e.g. Greek citizens vs. Germans – but the politicisation has led to the voiced desire among European citizens to distribute the costs of the crisis more along political lines (youth/ elderly; labour/ capital) rather than along national borders. For now, the European system is not yet equipped to deliver transnational political solutions and distribution, but citizens seem more eager than expected to get there. Unfortunately, national elites seem to not yet have understood this.

Hence, rather than being seduced by populist voices and politically rallying with them, one can only hope that some European party soon discovers this silent majority and starts calling for a different Europe, which means less technocratic, but more accountable, social and democratic!

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