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Towards a comprehensive, inclusive and legitimate framework for European economic governance

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European Economic Governance Project

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Executive Summary

- The immediate problem facing Europe, and in particular the Euro area of 17 member states, is to deal with crises affecting a number of countries, most recently Cyprus, but continuing in Greece, Portugal, Ireland, Spain, and possibly Slovenia. This has required a range of policy responses at both national and European level to contain and mitigate the crisis. But in the longer term the frameworks and institutions governing the EU and the Euro area need to be strengthened.

- Leaders have discussed the crisis response at many summits, and have proposed a number of far-reaching reforms, to improve national policy-making and improve Europe-wide policy coordination. These reforms cover most aspects of economic policy (fiscal, financial, macroeconomic and structural) and include measures to strengthen both ‘preventive’ (surveillance) and ‘corrective’ (policy change) mechanisms.

- Some of these have already been put in place, others have been decided but not yet implemented, and some are at the early stages of design. They all go in the direction of: greater **centralization** of decision-making; more detailed **rules** for national policies; and **sanctions** against member states that break the rules. They would move decision-making powers away from member states and towards European Union (EU) institutions, including the European Central Bank (ECB), which is statutorily independent, and the European Commission and EU-level authorities such as the European Banking Authority (EBA).

- Governments in a number of crisis countries are facing severe political pressures, which make implementation of policy changes difficult, especially if they are seen as being ‘imposed by Brussels or Frankfurt’. Longer term changes proposed in the Euro area will entail a further pooling of sovereignty from all member countries. Member states need to share in the ‘ownership’ of the policy changes inherent in building EU institutions, but this in turn requires generating more political legitimacy for EU institutions as well as the greater involvement by member states in decision-making.

- Other models of policy cooperation outside Europe (countries with federal structures, international financial institutions, and the Group of 20 - G20) can provide lessons. In order to be effective, policy coordination mechanisms need to be: **comprehensive**; **inclusive** and **legitimate**. The issue of democratic legitimacy goes to the heart of how the EU will evolve. Institutions need to be designed carefully to reflect the variable geometry of Europe.

- Given the existing structure of the EU and the Euro area, a number of practical steps can be taken to improve the framework of governance in Europe. It is most practicable to begin with those elements that have not yet been decided in detail.

- The proposed **Macroeconomic Imbalances Procedure (MIP)** is very welcome, since it addresses a big gap in the framework. However, it needs to be designed to involve member states fully in a similar fashion to the G20 Mutual Assistance Process (MAP).

- Over time **macroeconomic and fiscal elements should be integrated**, since current account and fiscal imbalances are strongly linked, and most of the burden for policy action rests with member states. Cooperative action in both areas will produce superior outcomes. Over the longer term a forum is needed to discuss the **interaction of fiscal and monetary policy**.

- In the absence of a central European fiscal authority, the institutions have proposed the creation of a **'banking union'** (which inter alia includes a single supervisor and a single resolution authority) which can involve member states more fully, since their actions would have considerable fiscal and economic implications for member countries.

Introduction

European economic governance, in particular in the 17 members states of the Euro area, is at a cross roads. The immediate problem is to deal with the crises in the Eurozone members affected, and a generic response to hold the single currency together. But the euro in particular faces a number of longer term structural problems[2]: countries in the periphery need to be able to live within the constraints of the single currency; the governance structures of the Euro area need to provide stronger sanctions; and Europe needs a growth model to allow the region as a whole, and its constituent parts, to grow sustainably.

So the frameworks and institutions governing the EU and the single currency need to be strengthened in order to improve the process of economic policy-making. Indeed, the perceived lack of a clear direction for these reforms has put further pressure (both market and political) on the euro and the EU, arguably until September 2012 increasing the likelihood of a catastrophic break-up. Designing appropriate governance structures could be crucial in determining the future of European integration.

Anatomy of Europe’s institutional crisis

The crisis in the Euro area is multi-faceted with roots in the EU’s institutional framework and governance, competitiveness in most member states, and in some cases banking crises and deficiencies in financial regulation. As such the Euro area crisis is less a debt crisis, at least for the moment. As Figure 1 below indicates, the total debt of all 17 Eurozone members is in fact lower than the total debt of the United States as a percentage of Gross Domestic Product (GDP), and it is significantly lower than Japan’s total debt. If the EU were a federal or nation state like the US, it would have a larger budget, a larger civil service and many more common policies. The EU budget is currently equivalent to only 1.2% of the EU’s GDP, whereas member state budgets are far larger as they retain major areas of expenditure such as health, social security, and pensions. Furthermore, the crisis in the Eurozone has yet to manifest itself as a currency crisis. For example, Graph 1 indicates the Euro has effectively fluctuated within the same range against the US Dollar since the beginning of the global crisis in 2008.

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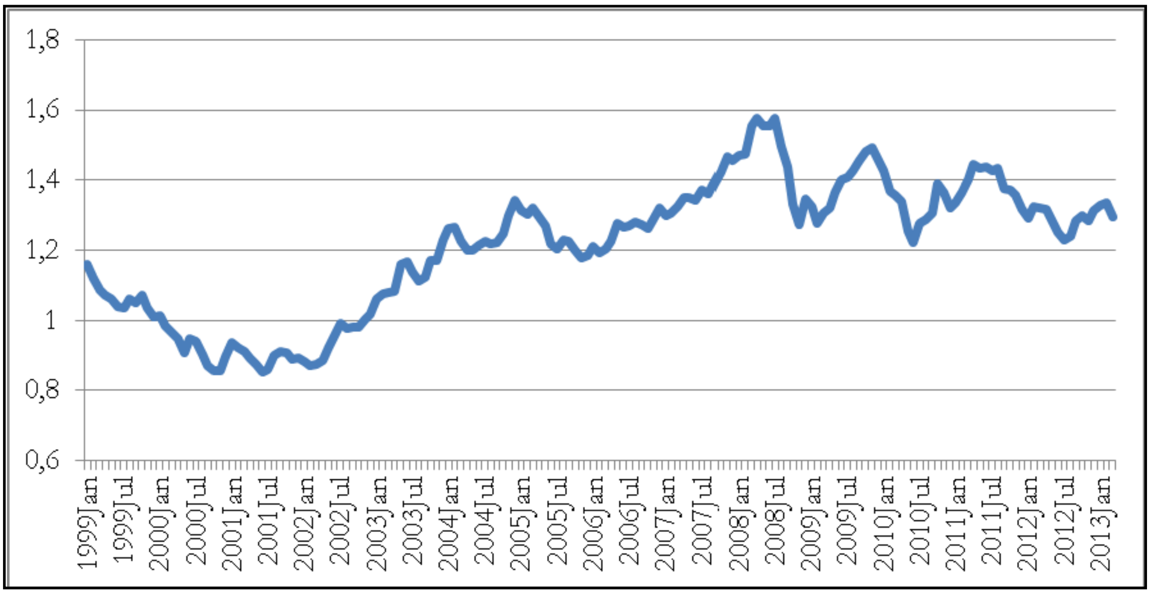
[2] *See ‘Broken Forever? Addressing Europe’s Multiple Crises’, by Paola Subacchi and Stephen Pickford, Chatham House briefing paper March 2012.*

Table 1: Gross Central Government Debt as a % of GDP in the Euro area and main OECD economies, 2000, 2005 and 2007-2011

	2000	2005	2007	2008	2009	2010	2011
Italy*	108.5	105.4	103.1	105.8	115.5	118.4	120.1
France*	57.4	66.7	64.2	68.2	79.0	82.3	86.0
Germany*	60.2	68.6	65.2	66.7	74.4	83.2	80.6
Euro Area**	69.2	70.3	66.4	70.2	80.0	85.4	87.3
United Kingdom*	41.0	42.5	43.9	52.0	68.3	75.5	81.8
United States*	54.5	61.8	62.4	71.8	85.8	95.2	102.9
Japan*	142.1	191.6	187.7	195.0	216.3	220.0	229.6

Source: IMF and Eurostat

Graph 1: Euro exchange rate against the dollar, 1999-2013



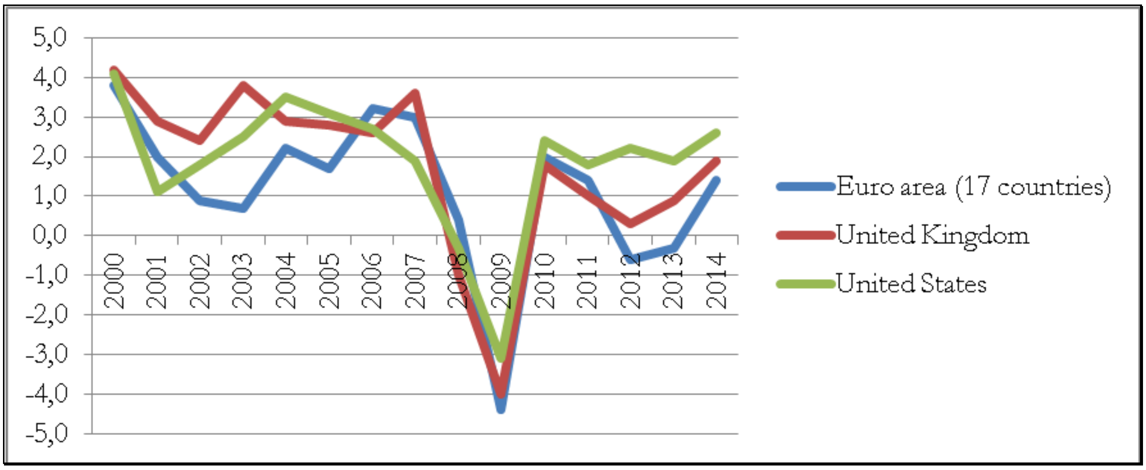
Source: ECB

Institutionally the EU is a hybrid of supranational and inter-governmental decision-making. The founding treaties provide for common policies to be proposed, monitored and sometimes enforced by the supranational and independent EU Commission. However, most pan-EU decisions continue to be made at the inter-governmental level involving all 27 nation states deciding by unanimity in the Council, often at the lowest common denominator. However, increasingly decisions are made by weighted Qualified Majority Vote (QMV) which roughly varies according to a member state's population. EU decision making is therefore slow and fragmented because governments, bureaucracies and citizens jealously guard powers, funds and special interests. The nature, scope and exercise of the division of powers within the EU therefore can help demonstrate why the Euro area crisis is effectively muddling through, lurching from one phase of the crisis to the next.

Anatomy of Europe's competitiveness crisis

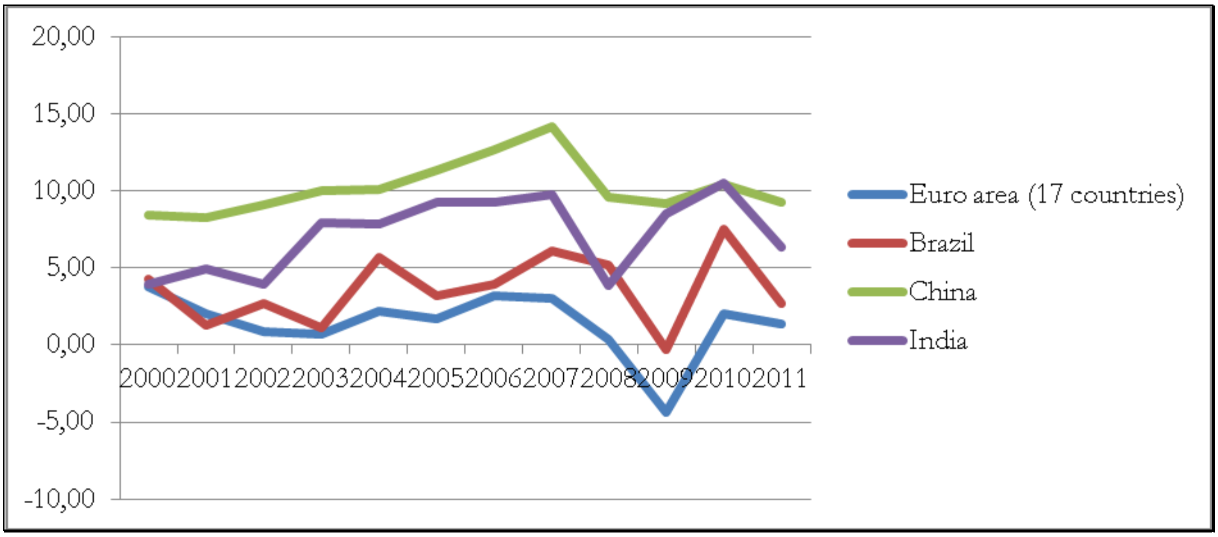
The crisis in the Euro area is exacerbated by flagging economic competitiveness in many member states. The root causes of declining competitiveness include: insufficient investment in and uncoordinated Research and Development, innovation, education and training; insufficient investment in high growth sectors (particularly Information Technology); poor productivity; inflexible labour markets; high non-wage costs (notably on social security and pensions); an incomplete Single Market, over-regulation and excessive taxation in some member states. As Graphs 2 and 3 indicate, growth rates since 2000 are lower than in the US and far lower than in China, India and Brazil.

GRAPH 2: Growth in the Euro area, UK and US, 2000-2014



Source: Eurostat

GRAPH 3: Growth in the Euro area, Brazil, China and India, 2000-2011



Source: Eurostat

Competitiveness in the Euro area is particularly affected by onerous labour market regulations which essentially aim to protect those in work but often have the opposite effect of increasing overall inflexibility in the labour market. 'Social contracts' involve more rigid labour market regulations (such as the 35 hour work week in France), generous social benefits, and high non-wage taxes. Less regulation governing the creation and termination of employment, combined with targeted welfare benefits and active employment and training policies can help.

Ageing populations is a problem in all developed economies, but the situation in the EU is particularly acute. More elderly will be dependent on fewer people of working age, thus further contributing to slower growth. A decline in the percentage of working age population will: lower investment, savings, and return on capital; and increase pressure on government budgets as older populations will require increased expenditure on health care and pensions. States can help meet these higher liabilities by stemming the decline in labour supply through incentivising higher labour participation rates, raising the retirement age and attracting immigration.

Member states failed to progress sufficiently the strategy agreed at the 23-24 March 2000 Lisbon European Council which aimed to tackle the EU's widespread lagging competitiveness through enhanced co-operation at the European level. Many believe the Lisbon Agenda lacked clear objectives as it involved 28 main targets, 120 secondary targets and 117 indicators. The Lisbon Agenda was regarded as being about everything and therefore about nothing, but ultimately the process lacked pan-European political will and coordination; had conflicting priorities, and implementation of its complex agenda was uneven. The Lisbon process has since been replaced by the Europe 2020 strategy, which also seeks to encourage structural reforms in Europe; but to date the results have been no more impressive. National austerity programmes in some member states, notably in Portugal, Ireland, Greece and Spain, are now having to address and implement some of the measures the Lisbon Process and its successor programme have so far failed to do.

Anatomy of the financial crisis

There have been three major phases of the financial crisis in Europe. In the first phase (2007-2009) a number of European countries experienced financial stress as global markets seized up. The UK, Ireland and Iceland were particularly badly affected by the lack of access to finance, and confidence in their financial sectors plummeted. Actions taken by their governments to restructure and rebuild their financial sectors have left them with high fiscal deficits and public sector debt. The second phase of the crisis (2010-2011) saw a worsening of debt dynamics in countries that failed to address their fiscal problems, exacerbated by a loss of competitiveness. But over the last two years a third phase has seen a wider European problem develop. Countries in the periphery of the euro, many of which started off with substantial weaknesses on the fiscal or financial side (or both), began to suffer from economic and political contagion.

In the latest phase financial, economic, fiscal and political concerns have fed on each other, exacerbated by the specific constraints of the euro which further exposed the lack of competitiveness in periphery countries in particular. As a result, a number of these countries (in particular Greece and Spain, and to a lesser extent Portugal and Italy) have entered a vicious cycle of financial sector weakness, high fiscal deficits, rising borrowing costs, weak growth and rising unemployment, consequent political tensions, and in some cases violent protest.

Crisis responses

Policy-makers have taken a number of steps to respond to this systemic European crisis. All European countries have adjusted **national policies** in response to the crisis. But the degree of change has varied greatly, and implementation has been patchy. Those facing the biggest policy challenges have had to adjust significantly. However, there is a wide divergence of experiences. Some, like Ireland, have introduced far-reaching reforms across a broad range of policy areas, including very ambitious fiscal consolidation. Others, such as Spain, have been slow to put in place policies to address the problems they face. In the case of Greece, policy changes have fallen short of what was judged necessary (either by the troika[3], or by the markets).

The ECB has provided **liquidity** in large amounts, as European banks and sovereigns have struggled to access financing from capital markets. Two tranches of long-term refinancing operations (LTROs) have been followed by the outright monetary transactions (OMT) scheme. But in the absence of credible measures to deal with the root causes of the problems, ever-increasing liquidity support has been needed. The OMT scheme potentially provides unlimited liquidity to countries in crisis (and indirectly to their banks), but with policy conditionality at its heart: in order to access finance through the OMT, countries have to request a support programme with the European Commission.

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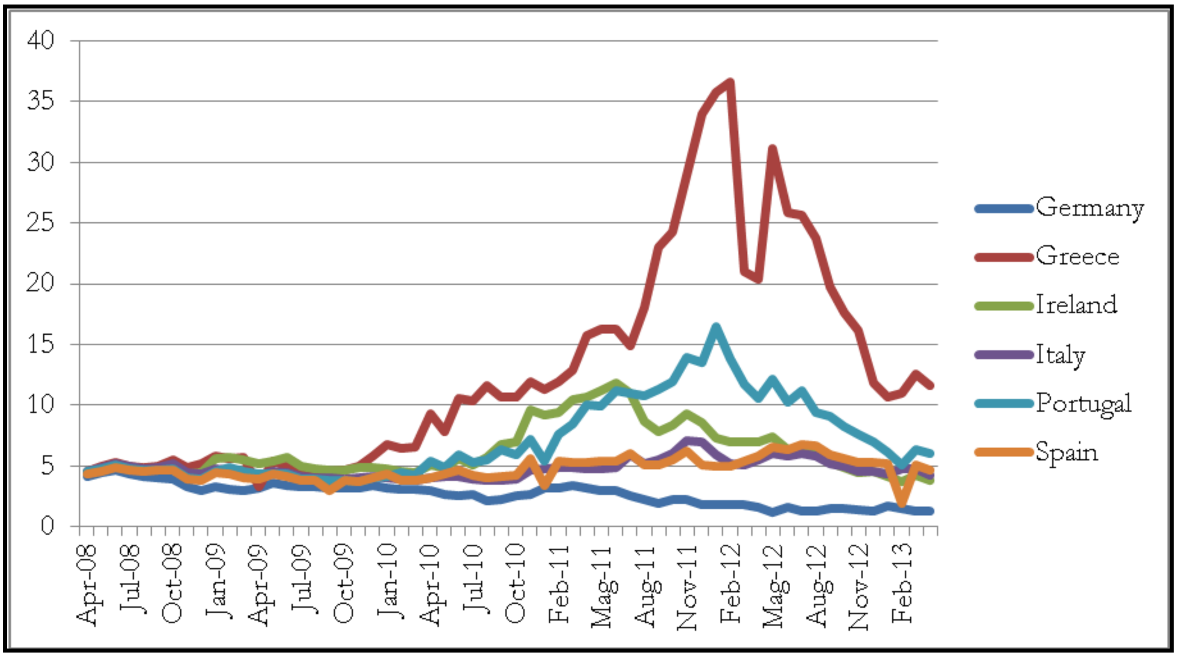
[3] *The three institutions monitoring Greece's adherence to its policy programme, triggering emergency financial assistance – the European Commission, the ECB and the IMF.*

As the crisis deepened, Europe has tried to erect ever-larger **firewalls**. These were designed ostensibly to prevent contagion to 'innocent bystander' countries, but have primarily been used to finance adjustment by the most crisis-affected countries. First the European Financial Stability Facility (EFSF), followed by the augmented European Stability Mechanism (ESM), have been put in place, making up to €500 billion of finance available. But at each stage political leaders have disagreed about the amounts needed, and the conditions attached, as well as who should pay. In the meantime, as part of the troika, the International Monetary Fund (IMF) has helped co-design and co-finance adjustment programmes. In the case of Greece, this included private sector involvement, as private debt was voluntarily written down. As the crisis has progressed, and the level of financial support has increased, the level of **conditionality** attached has also been raised: the joint EU/IMF programs, ESM, and OMT all require substantial policy changes by member states accessing these support mechanisms. However, the precise level of conditionality is still being debated, with the 'creditors' seeking much tougher reforms (especially fiscal) than the 'debtors' want.

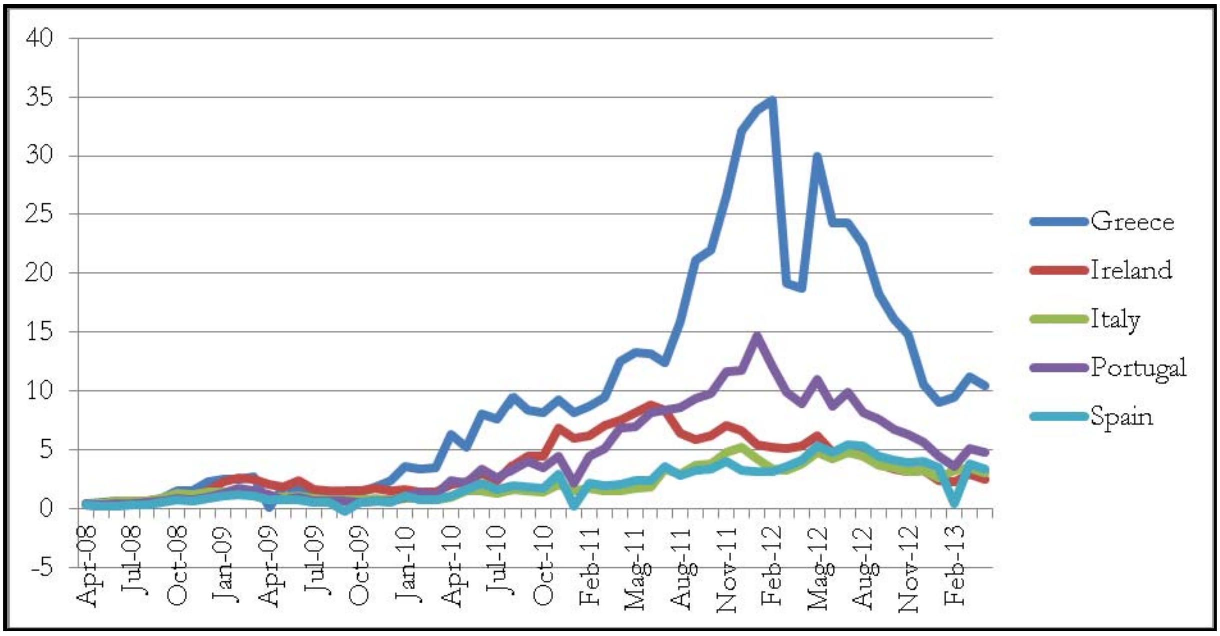
Euro Group policy-makers have struggled to frame an appropriate response. There has been a sharp divergence in particular between the 'creditor' countries in the North (or the 'core' of the euro area), and 'debtor' countries, most of which are situated in the South (or 'periphery'). As these tensions have increased, markets reacted badly to the slow progress in framing a comprehensive response; as a result borrowing spreads for the crisis countries ratcheted up, and expectations of a break-up of the euro increased. When the Euro was launched, yields on government bonds of Euro area members converged in the belief that its disparate economies shared the same currency and monetary arrangements under the ECB. Differences in the structure and strength of, for example the German and Greek economies, was overlooked (other than the weak attempts to address competitiveness through the Lisbon Process). As Graphs 4 and 5 below indicate, markets ignored underlying economic divergence and imbalances. This was reflected in low spreads between the yields of German government bonds (Bunds) and the sovereign bonds of other Euro area members. However, after the Lehman crisis in 2008, yield spreads between 10 year national bonds and German Bunds began to diverge again, particularly in the case of Greek, Portuguese and for two years Irish bonds.

Graph 4: Selected Euro area government bond yields, 2008-13



Source: Financial Times market data

Graph 5: Selected Euro area government bond yield spreads against German Bunds, 2008-13



Source: Financial Times Market Data

Governance responses

EU leaders have also at their many summits sought to introduce far-reaching reforms to strengthen national policy-making and European-wide policy coordination. Monetary policy is already a single construct, common to all countries in the euro area. Recent summits have addressed most other aspects of economic policy – fiscal, financial regulatory, structural, and macro. Reforms include both 'preventive' measures (tighter surveillance of national policies) and 'corrective' measures (systems for requiring policy adjustments where necessary).

Many ideas for reforms have been put forward in the last two years. Some have already been put in place, and a number of other changes have been decided but not yet implemented. Some reforms are restricted to the euro area countries, others include 'outs' who want to participate, and some cover the entire EU.

Fiscal reforms

Most of the reforms proposed to date have related to fiscal policy. The Stability and Growth Pact (SGP) dates back to the earliest days of Economic and Monetary Union (EMU), but it has had a chequered history, with hard decisions often avoided in favour of political expediency[4]. Despite the efforts of the Commission (who are the guardians of the Pact) with the strong support of the ECB, member states have tended to opt for 'peer protection' rather than 'peer pressure'.

Since many governments, especially the 'creditors', regard lack of fiscal discipline as at the heart of the euro's problems, the last three years have seen a number of proposals which significantly toughen the fiscal framework, with stronger requirements on euro area members than on non-members[5].

The SGP's '**preventive arm**' (the Commission's surveillance mechanism) has been strengthened as part of the 'six-pack', requiring countries to make significant progress towards their medium-term deficit objectives (MTOs), with expenditure

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[4] Greece and Italy joined the single currency with public debts well in excess of the 60% of GDP limit laid down in the Maastricht Treaty. And breaches of deficit ceilings by France and Germany in the early 2000s did not result in the fines laid down in the SGP.
[5] For example, the Fiscal Treaty is binding on all euro area members, while other EU countries can participate (but the provisions only become binding when they join the euro). The 'six-pack' applies to all EU member states, but some provisions (applied by reverse QMV) only apply to euro area members.

benchmarks added to the deficit benchmarks to measure progress; and the Treaty on Stability, Coordination and Governance (the Fiscal Treaty), signed up to by all but the Czech Republic and the UK, establishes a balanced budget rule.

The '**corrective arm**' (the mechanism for requiring countries with excessive deficits to take corrective action) has also been bolstered in the 'six-pack': the excessive deficit procedure (EDP) can now be triggered by excessive debt as well as deficits, setting a time-path of adjustment to the 60% debt level. Furthermore, the Fiscal Treaty strengthens the requirements on countries in the EDP (especially on Euro area members), by introducing reverse QMV to set a presumption in favour of the Commission's recommendations for action.

Sanctions have also been increased for breaches of the SGP, both in the 'six-pack' and in the Fiscal Treaty, through non-interest bearing deposits at the ECB, interest-bearing deposits for graver breaches, and fines of up to 0.2% of GDP as the ultimate sanction.

National budgetary frameworks have also been prescribed more strictly. The 'six-pack' requires minimum quality standards, multi-annual planning, and numerical fiscal rules; while the Fiscal Treaty goes further and requires debt brakes and national MTOs to be incorporated into countries' constitutional laws. The 'two-pack' currently being introduced will require the establishment of independent national bodies to produce macroeconomic forecasts and monitor compliance with national fiscal rules.

Finally, national **budgetary timetables** are prescribed in order to facilitate review and assessment by other member states and the Commission: the 'two-pack' and the European Semester set common deadlines for countries' budget processes (allowing the Commission to request revisions to a draft budget).

The Commission has proposed going further, and developing a 'fiscal capacity' for the euro area, based initially on 'contractual arrangements' between member states and the Commission to encourage implementation of structural reforms. This would be followed by a central fiscal capacity to allow countries to respond to economic shocks through an insurance system. However, EU leaders at the December 2012 summit deferred any decision on these further steps.

Financial reforms

Since the onset of the global financial crisis in 2008, it has been a priority to strengthen financial regulation in the EU, recognising the economic damage done by the crisis, the fiscal consequences, and the spill-overs across national borders.

Early in the process, a new **pan-European regulatory architecture** was set up, with the creation of European Supervisory Authorities (ESAs) for banking, insurance and pensions, and markets to advance a single rule-book for the financial sector. The European Systemic Risk Board (ESRB) was created to carry out macro-prudential oversight within Europe. Also European **directives and regulations** (drafted by the Commission) have been toughened significantly, including for capital requirements, insurance supervision, shadow banking, market abuse, Over the Counter (OTC) derivatives, credit rating agencies, and banking pay structures.

A group was also set up (the **Liikanen group**) to look into further reforms to the structure of the banking sector in Europe, following the Dodd-Frank legislation in the US and the Vickers Commission in the UK. The group's October 2012 report proposed a form of legal separation between retail banking and investment banking to limit taxpayers' exposure to bank failures.

Discussions are also now taking place about the creation of a 'banking union' to complement economic and monetary union. This is one of the key recommendations of the report of the '**Quadriga**' (comprising the four Presidents of the Commission, the Council, the ECB and the Eurogroup) published in December 2012. It proposes: a Single Supervisory Mechanism (SSM) for banks, under the ECB; a common resolution authority, with its own financial capability, to recapitalise and resolve failing banks, and harmonisation of national deposit guarantee schemes for financial institutions.

The December 2012 summit agreed to proceed with the SSM providing for ECB oversight of euro area banks with assets greater than €30 billion (up to 200 banks in total, but only about 1% of all Eurozone banks) to come into effect by the beginning of 2014. But, again, decisions on the other two elements were deferred. The common resolution authority in particular would have potentially far-reaching implications for fiscal burden-sharing between member states.

Structural reforms

The economic structure of many EU member states has been a major contributing factor to the economic crisis. In order to stimulate growth through structural reforms, a Europe-wide process was undertaken. As noted above, the **Lisbon process** was launched in 2000 to monitor progress at the country level, by setting targets and peer review. Most measures were for national governments to take, as the powers and instruments lie within national competence. However, further attempts to complete the single market and cross-border initiatives (including infrastructure projects such as Trans-European Networks - TENs) were complementary measures at the EU level.

In reality, some countries have pressed ahead further and faster with structural reforms, while others have lagged behind. Accordingly, the Lisbon Process was widely believed to have failed. Nevertheless, the Commission launched in 2010 the **Europe 2020 strategy** aimed at promoting sustainable and inclusive growth, setting targets for every member state, and monitoring implementation. In Spring 2011, the **Euro plus pact** was agreed by many member states, aimed at promoting competitiveness and growth. The proposal for a **Compact for Growth and Jobs** has since been launched, with additional financing for infrastructure through the European Investment Bank (EIB) and through reallocation of structural funds, as well as measures to deepen the single market, complete the internal energy market, and reduce the regulatory burden on business. But given the experience of the Lisbon Process, and the need to ensure that action happens primarily at the national level, it is hard to be optimistic that these efforts at coordination across Europe will fare much better.

Macroeconomic imbalances

During the first decade of the single currency's existence, closer coordination of fiscal policy was seen as necessary to support the euro area single monetary policy. However, with the onset of the euro crisis, not only was tighter and more effective fiscal coordination seen as necessary, but dealing with macro imbalances also came to be seen as crucial.

Through the 2000s macro imbalances between the members of the euro area increased steadily, with countries in the core tending to see improvements in their relative competitiveness, and the periphery countries suffering relative declines, which the single monetary policy and single short-term interest rate for the euro area as a whole could not counteract (and in some respects exacerbated). As a result, through the decade core countries (in particular Germany) saw their current account surpluses increase, while periphery countries ran increasingly large current account deficits.

The realisation that these imbalances mattered for the sustainability of the single currency has led to proposals in the 'six-pack' for a new process to prevent and correct macroeconomic and competitiveness imbalances. The **Macroeconomic Imbalances Procedure** (MIP) is intended to use a scorecard of indicators to warn of imbalances building; recommendations to correct these imbalances (the Excessive Imbalance Procedure - EIP); and sanctions for countries that do not implement the recommendations.

Assessment of the response

The response to the crisis has extended the framework across the full range of economic policies, and has strengthened and deepened the level of policy coordination. National governments have made policy changes (in some cases far-reaching changes); EU institutions (especially the ECB) have responded to the crisis by providing bigger firewalls, boosting liquidity, and encouraging policy changes; and the governance arrangements in the EU, and in particular the euro area, have been substantially rethought. In particular the reassessment of what is required to make the single currency work is very welcome, and overdue, although not all member states and central banks have agreed with the ECB's apparent extension of its mandate.

However, the crisis is still not resolved. In part this is because the response has been slow and patchy. The process of negotiating adjustment programmes between individual crisis countries, the troika, and the other 26 member states has been difficult. The longer term governance changes emerging from successive summits have appeared piecemeal, and designed in large part to respond to the crisis of the day. As such, responses have often not confronted many of the roots of the crisis lying within national competence.

The various governance changes are at different stages of completion. Some have already been put in place; some are awaiting ratification; some have been endorsed in general terms but need to be spelled out in detail; and some are still at the proposal stage. Nevertheless, taken together they represent a significant shift in the contours of European economic governance. The important question is whether they amount to a coherent and integrated structure which puts in place effective coordination of policies across Europe (especially the single currency where the requirements of coordination are much greater) and provides incentives for countries to implement the policy changes required at the national level to deliver stability and growth at the euro area and EU level.

The evolution of the crisis

By September 2012, the crisis in the Euro area appeared to have turned a major corner with agreements to and announcements of new instruments, such as unlimited bond purchases under its OMT programme, by the ECB and a ruling by the German constitutional court that Germany's participation in the €500 billion ESM bailout facility was legal. While "the political risk of a country leaving the euro is not eliminated … the risk of a forced default of a large continental economy that could unleash large-scale bank defaults and a balance of payments crisis is now contained."[6]

However, the Eurozone crisis is far from over. The ECB's bold actions have bought time while it is hoped governments implement supply side and fiscal reforms to allow many economies to resume growth. It is feared though that populations and voters are increasingly succumbing to 'austerity fatigue'. Furthermore, the Bundesbank is reportedly arguing it is not the duty of the ECB to rescue states in crisis through the use of the OMT. If the German Constitutional court were obliged to rule on aspects of EMU again, "it might cite the Lisbon Treaty stating that the ECB has a duty to support the general economic policies in the Union."[7]

Ultimately, the choice is between the highly disruptive collapse of the Euro area or the creation of a loose federation (the 'Eurogroup') which, in addition to the ECB, might involve the creation of its own finance ministry and common economic policies,

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[6] *Lena Komileva, Chief Economist, G+ Economics, quoted in the Financial Times, 8 September 2012.*
[7] *Daily Telegraph, 27 April 2013, p. 34.*

taxation and regulatory arrangements. President Barroso of the European Commission, the UK Chancellor, and others have proposed such federal arrangements as one way to resolve the Eurozone's governance crisis: "If the survival of the Euro requires further political integration… then member states need to share more decisions at European level, but also accept more interference by EU institutions in areas previously held to be the preserve of national authorities."[8]

Other models of policy coordination

There are a number of models across the world, which could provide lessons for Europe. In particular, they may provide lessons on: how to provide effective surveillance of performance at the national level; how to coordinate the actions of the 'centre' and of the member states; and how to ensure that commitments (by both the 'centre' and the member states) are implemented fully.

A number of large countries have federal structures (eg the US, Canada, India, and to some extent Germany) where the components of the federation have a greater or lesser degree of autonomy. What they have in common is a clear division of responsibilities between the components and the centre, often set down in law.

On surveillance, they often employ a single, highly respected body at the federal level (eg the US Federal Reserve, or the German 'wise men' for economic forecasting) to carry out analyses on a common basis, but making full use of expertise at the component level (for example, the Fed's 'Beige Book'), so that the analysis and judgements made are as far as possible shared across the federation. On policy coordination and implementation, the most important joint decisions are usually fiscal (since all have a monetary union). Although the degree of fiscal autonomy varies substantially, federal structures require 'rules of the game' agreed in advance, and a regime for punishing anyone who breaks the rules. So in some unions the component parts may be able to borrow in their own right; but if so, they need to bear the consequences of their own actions.

Another model of coordination is to employ an outside body. For surveillance, the IMF and OECD have played this role for many years. Their ability to carry out this

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[8] *Lorenzo Bini Smaghi, Financial Times, 8 August 2012.*

effectively depends on them being perceived as independent, knowledgeable, and even-handed. The criticism of IMF surveillance is often that the messages are watered down[9], either because they need to maintain a relationship with the country being reviewed or because the IMF Board exercises peer protection – preventing hard messages from being delivered, at least in public. The OECD model is rather different, with national authorities invited to review each other, on the basis of the staff's assessment. The final product is owned by the countries collectively, rather than the staff. But again, peer protection is often the end-result.

Outside bodies are used less for coordination of policies across countries. One of the few examples of a formal process was the multilateral consultation conducted by the IMF to address the issue of global imbalances. It is generally regarded as not very successful as an experiment. Staff were clearly knowledgeable, but the exercise foundered on a lack of ownership on the part of the countries involved. Although they cooperated in the process, it was managed by the IMF; and the policy conclusions as a result were not acted on.

The third model of coordination is the G20 mutual assessment process (MAP). The MAP was set up to operationalize the Framework for Strong Sustainable and Balanced Growth agreed at the Pittsburgh summit in 2009. From the outset the MAP was designed as a process managed and owned by the G20 countries, but drawing heavily on the technical expertise of the IMF and other international bodies. Key aspects of the MAP are: it derives its legitimacy from G20 Leaders' commitment to the Framework; it is based on countries' own forecasts, although the IMF ensures consistency at the global level; if the outcomes based on these forecasts are agreed to be unacceptable, the IMF develops alternative scenarios based on different policy settings, the G20 choose between these scenarios and develop an action plan, and the G20 also monitor implementation of policy commitments agreed.

The MAP (see Box 1) is still in its early days, but the initial signs are fairly encouraging. Countries have developed a high degree of involvement at all stages of the process, though it is unclear how far they will commit to policy changes.

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[9] *See for example the report of the IMF's Independent Evaluation Office, 'IMF performance in the run-up to the financial and economic crisis: IMF surveillance in 2004-07' published in 2011.*

Box 1: The G20 Mutual Assessment Process (MAP)

MAP was initiated by G20 leaders at the Pittsburgh Summit in 2009, as the global economy was starting to emerge from the global financial crisis. The G20 faced internal disagreements about how quickly to unwind the exceptional fiscal and monetary stimulus measures taken during the crisis, and there were real risks of a reversion to protectionism. MAP was intended to reduce those tensions. It also reflected dissatisfaction with the 'standard' instruments of IMF surveillance, which suffered from a perceived lack of even-handedness and independence. There were also questions about the IMF's model for policy advice and the IMF was seen as lacking in traction on countries' policies.

In the light of an unsuccessful attempt at international policy coordination to address global imbalances, the IMF's 'Multilateral Consultation', MAP was designed rather differently:

- By involving all G20 countries, MAP covers most major economies, accounting for over 80% of the global economy, and encompasses all aspects of policies – fiscal, monetary, structural and trade – to improve growth, address imbalances and avoid protectionism.
- As a mutual assessment process, MAP is designed to improve ownership of the process by the countries involved.
- The IMF's involvement is relatively limited, providing technical expertise and support, but not driving the process.

- The IMF inputs to MAP have been published in a very transparent manner; and while the G20 discussions are in private, the outputs from the process are also publicly available.
- MAP is a peer review process rather than surveillance.

- MAP is not shying away from some of the most difficult issues currently facing the global economy – when and how to withdraw stimulus measures, how to address global current account imbalances, exchange rates and other forms of protectionism.

- It appears to be providing a forum in which countries can discuss each others' policies frankly. Brazil has been particularly willing to speak out publicly about exchange rate policies of other economies – another sign that the economic policy debate is opening up.

- The Seoul Summit produced some policy commitments by countries in the areas of monetary and exchange rate policies, trade and development, fiscal policies and financial and structural reforms (although at this stage they are rather general).

- Seoul also pledged to enhance the process, including through indicative guidelines against which to measure economic imbalances.

MAP is in its infancy, and it is still uncertain whether the process is capable of producing hard-edged policy prescriptions, and whether countries will implement their agreed commitments. The next round of MAP discussions will provide a clearer indication of how far countries are prepared to subordinate short-term national interests to international cooperation and coordination of policies. Also, as the global economy becomes even more diverse and multipolar but also more interdependent, it will show whether a system of country-led mutual peer review is more effective than current surveillance processes in encouraging countries to adopt policies that are in the global interest.

MAP is thus a deliberate attempt to overcome some of the issues that have hampered the effectiveness of IMF surveillance, namely clarity of objectives (although, by being linked to G20 objectives, MAP's clarity depends on whether the G20 itself is clear about what it wants) and the establishment of an integrated diagnosis (which pays more attention than before to interdependencies and their impact). Because MAP is clearly driven by the leaders themselves, it has the potential to better support an effective governance framework through greater impetus for the transparent sharing of information and through accountability resting at the highest level and sustained by the leaders' commitment to the G20 itself. Nevertheless, even as these represent hopeful developments, a breakthrough remains in doubt until the elements of a coherent and agreed framework for international cooperation are in place.

The step towards credibility that MAP offers is the collective call from the G20 for a 'candid assessment', or greater openness, in how countries exchange data, scenarios and views on how their individual policies interact in support of the health of the global economy. Moreover, it is the effectiveness of this information-sharing process that will be critical in engaging the leaders and, subsequently domestic constituents in meeting the objectives of the global economy. By providing a framework for identifying the benefits of cooperation, MAP provides G20 countries with an opportunity to sustain greater levels of cooperation.

Source: Subacchi and Jenkins, April 2011

An alternative model for European economic governance

The European model for economic policy decision-making is still evolving. In particular, there are a number of major reforms planned or in the pipeline which (if implemented) would fundamentally change its character. But based on experiences in recent years they are likely to fall short of what has been proposed.

The crisis exposed the shortcomings of the framework, which European policy-makers are now trying to address. The lack of a coordinated approach to national policy-making, and an unwillingness of some countries at times to adhere to the policy 'rules', has been a part of the problem. So the current moves to strengthen incentives for countries to adopt policies that are more coherent at an EU-wide level are a step in the right direction.

The framework as currently planned would result in a high (and rising) degree of **centralization**. The ECB sets monetary and exchange rate policy for the euro area as a whole. Also, the Fiscal Treaty gives wide-ranging powers to the Commission, and prescribes specific standards for national budgetary processes. The proposed **banking union** provides an integrated framework comprising regulation, supervision, bank resolution, and deposit guarantee schemes. The banking union is not a short term rescue mechanism as implementation of politically expedient elements are scheduled first. Different supervisory controls not only hinder integration but also contribute to the dependence of banks on their respective governments and taxpayers. To break the loop between banks and their sovereigns, leaders agreed the transfer of supervision of all banks to the Single Supervisory Mechanism (SSM) under the ECB umbrella, often in conjunction with national central banks. A European Resolution Authority is particularly important because effective supervision needs to be able to assess whether a bank has attained the point of non-viability, and authorities need the power to decide whether a bank should be wound up (though it is not clear who would bear the accompanying fiscal cost). The complement to European bank resolution is a European deposit guarantee framework. Uniform minimum coverage of €100,000 was introduced in 2009, although this was temporarily and contentiously disregarded in the case of the Cypriot Government's recent proposals for its bail out. EU-wide deposit insurance is politically more difficult because it involves the underwriting of banks elsewhere. For example, German small banks fear some banks (for example the *Cajas* in Spain) may seek to free-ride, resulting in the *Landesbanks* having to end up subsidising them.

A detailed set of **rules** governing how member states should conduct policy is needed. This is most developed in the area of fiscal and monetary policy. Member states will face tighter constraints on fiscal policy, both their policy settings and their fiscal frameworks. Eurozone members have no discretion on monetary policy settings. The European Supervisory Agencies (ESAs) would draw up a single rule-book for financial regulation. The proposed macro imbalances process will require guidelines to be developed, which will begin to bind countries on a broader set of economic policies.

Lastly, **sanctions** should be levied against member states which break the rules. The SGP has incorporated the possibility of sanctions for member states that breach the fiscal guidelines, but in the past these have not been applied rigorously. The Fiscal Treaty and the Quadriga report proposes toughening these sanctions considerably and extending them.

A high degree of policy coordination is desirable if the euro zone is to move towards full economic integration. Indeed, it is likely to be necessary in a single currency area if policy settings for the zone as a whole are to be optimised, and the burden of adjusting imbalances is to be spread equitably between surplus and deficit countries.

The proposed framework needs to meet a number of criteria in order to function effectively. Firstly, it needs to be **comprehensive**. In the euro zone monetary policy is fully integrated, but fiscal policy is focussed only on correcting excessive deficit and debt levels, rather than what is the optimal fiscal policy setting for the area as a whole. Also, at present little or no consideration is given to macro imbalances. The proposed macroeconomic imbalances procedure could correct this to some extent, but it needs at least to be given as much weight as the fiscal policy framework; and the two should be fully integrated. This has important consequences for the organisation of policy coordination.

Secondly, it needs to be **inclusive**. One important lesson from other examples of policy coordination is that there needs to be strong ownership of the agreed policies. Even within a federal structure the sub-national entities need to respect the rules of the game. And within Europe at present this is even more important since the responsibility for important parts of policy-making rests with member states. This is being demonstrated clearly at present, as some governments are resisting the attempts by the centre to impose greater fiscal austerity, even under the extreme circumstances of a support programme (such as in Greece). Under less extreme conditions, it is likely that member states will also not be willing to accept policy changes imposed on them unless they feel part of the process, both of identifying problems and of crafting solutions. One solution is to create an effective forum for member states collectively to review each others' policies, develop a mutually-agreed set of policy responses, and monitor implementation by countries.

Lastly, it needs to be seen as **legitimate**. Economic policy decisions taken at the national level, even by independent agencies, are subject to scrutiny by and accountability to national parliaments. This provides democratic legitimacy. But under the proposals economic decisions will increasingly be taken at the European level, either by the Commission, the Council, the ECB or the ESAs and other union-level institutions. The 'variable geometry' emerging in Europe adds another layer of complication, as processes develop involving the euro area members, the EU 27, or somewhere in between. The accountability systems are also complex: the Council is comprised of member state governments which are accountable to national parliaments; the Commission shares some law-making powers with the European Parliament (under co-decision); and the ECB is governed by national central bank governors (although they do not represent their countries on the governing council). All these bodies are to some degree accountable to the European Parliament, but (although directly elected) it is relatively powerless to challenge decisions by the executive institutions. The Quadriga report clearly identifies this as a problem and argues for stronger democratic accountability, to both the European Parliament and national parliaments, though without coming forward with concrete proposals.

Recommendations

To achieve these criteria, a number of practical steps should be taken. It will be more difficult to make changes to existing processes (such as the SGP) than to redesign ones where the detail is still being worked out (in particular the Fiscal Treaty, the macroeconomic imbalances procedure and banking union).

Concrete recommendations to provide a comprehensive, inclusive and legitimate framework for economic governance are that:

1. The **MIP** should be designed to involve member states fully from the start. This means that it should be owned by national governments, rather than driven by the Commission or the ECB. As with the G20 MAP, it should be based initially on national forecasts, though open to challenge by the Commission or the ECB. And national governments should be presented with a menu of policy options to choose from, rather than being imposed by the central institutions. This is especially important in respect of current account imbalances, since surpluses and deficits are mirror images. However, as the G20 MAP has demonstrated, it is very difficult to achieve consensus on policy changes when important national interests are seen to be at stake. Given the greater degree of policy coordination in the euro area, there also needs to be a process for reaching agreement without consensus, through a binding mechanism (such as some form of qualified majority, or preferably double-majority, voting).

2. The MIP should also over time **incorporate the SGP**, since fiscal policy decisions clearly influence (and are influenced by) current account positions. This would also help focus the SGP discussions more on the appropriate stance at the European or euro area level. By moving the SGP towards a process that is owned by member states, it should also increase ownership for decisions resulting from the SGP process and improve the chances that they will be implemented at the national level.

3. A forum also needs to be created to discuss the **interaction of fiscal and monetary policy** settings. This will happen only over the longer term, given the statutory independence of the ECB. And since fiscal policy settings are changed only once a year, monetary policy will be the main instrument for short-term responses to events. But if the ECB were more open to a discussion with national governments of

the appropriate balance of monetary, fiscal and other economic policies, in principle its task would be made easier, since all economic policy levers would be pulling in the same direction

4. Lastly, a **banking union** involving a SSM and single resolution authority proposed by the Quadriga report also need to involve member states fully. Governance of the banking union will be a major issue in relations between Euro area and non-Euro area members. In particular, it is feared a banking union, dominated by many member states with small financial sectors, could have enormous implications for non-Euro area member states with large financial sectors (such as the UK) which may or may not join.

At the extreme these new bodies could decide that a large European bank should be recapitalised or wound up, with potentially huge fiscal and economic implications for member states individually and collectively. Without a central European treasury, it is difficult to conceive that national parliaments would be willing to entirely pass over responsibility for these decisions to independent bodies, without being able to scrutinise these bodies and holding them to account. Previous discussions on how to resolve failing cross-border financial institutions in Europe have always foundered on the issue of fiscal burden-sharing. These new institutions will have to address the same issue, and finding a way to involve member states in the decisions they take is one way to do so.

The main theme running through this agenda is the need to build ownership by member states – at least as long as the EU is not a full political union -- for decisions that have to be taken at the European level, but which either require policy actions at the national level or have profound implications for countries. Drawing on the example of the G20, the conclusion drawn here is that EU national leaders need to buy fully into a plan that delivers strong, sustainable and balanced growth for Europe. That requires finding ways to integrate the different strands of economic policy, to design better processes for policy coordination to deal with spill-overs and free-rider issues, and to involve member states in decision-making, so that they fully buy in to the conclusions and take the actions needed at national level to implement them.

This agenda will require substantial changes to the way Euro area operates, at both national and supranational levels, and will have implications for the division of responsibilities between member states, European institutions, and parliaments. In particular, it will require the Commission and the ECB to be more open to involving member states in the decision-making process, and member states be more willing to pool and make decisions at the European level. But if it results in more effective and coordinated decision-making, that delivers better policy outcomes across the euro zone and EU, it will be worth doing. A start should be made with the new procedures being designed now to address macroeconomic imbalances and to strengthen the integration of financial services across Europe.

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