EUROPEAN ECONOMIC GOVERNANCE

by Andrew Watt

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EUROPEAN ECONOMIC GOVERNANCE:

WHAT REFORMS ARE TO BE EXPECTED AND WHAT ARE NEEDED?

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INTRODUCTION

Right from the beginning, the economy has been central to the whole process, and the political project, of European integration: it is often forgotten that what is now the European Union was once the European Economic Community (EEC). Economic policy, on the other hand, was, until comparatively recently, very much a national matter. Trade policies were, of course, integrated at an early stage. The Common and subsequently the Single Market imposed some limitations on government interventions in the economy, for instance in the area of state aids to domestic producers. But the main responsibilities for economic outcomes – growth, productivity, employment, inequality – and also the main levers of economic policy – monetary and fiscal policy, employment and welfare policies – remained in national capitals. Industrial relations systems responsible for setting wages and working conditions were often located at sub-national level.

As European integration progressed, however, policy coordination needs increased and, in a discontinuous process, concrete steps towards a more integrated economic policy framework were taken. As background to the main body of this article dealing with recent debates on reform, some of the most important developments are very briefly reviewed in the next section. We then look at the implications of the still ongoing economic crisis for the debate on economic governance in Europe and the reform proposals put forward by the European authorities. These are then critically assessed before presenting a number of alternative policy proposals.

ECONOMIC GOVERNANCE IN THE PROCESS OF EUROPEAN INTEGRATION: A SKETCH

The first major step towards more integrated economic policies came with the European Monetary System, set up in 1979 to provide for fixed-but-variable exchange rates between the leading (west) European economies. It constrained, in the short to medium run, the monetary policies of all member countries except Germany, the issuer of the de facto anchor currency, the D-mark. Fiscal and other policies remained unaffected, however, not only institutionally, but also practically given that currencies could always be realigned (re- or de-valued) to restore competitive relations.

This changed with the transition to European Monetary Union (EMU) in 1999. With the creation of the European Central Bank (ECB), participating countries abandoned control over monetary and exchange-rate policy. In the run-up to EMU, fiscal policy had been – in legal terms – tightly constrained by the Maastricht Treaty and these constraints were subsequently further reinforced by the Stability and Growth Pact. The Treaty and Pact provisions sought to limit (current) deficits and, in theory, government debt. The restrictions were necessary, it was argued, because the centralisation of monetary policy meant that governments would no longer be constrained by bond markets from running deficits and maintaining high debts levels, a situation that would put upward pressure on inflation and thus interest rates. Thus the limitations were needed to prevent this 'negative' externality from hurting also the fiscally prudent countries.

However, governments repeatedly broke the SGP rules with impunity in the recession that followed the implosion of the dot.com bubble. As a result, the Pact was reformed in 2005, with a focus on structural (i.e. cyclically adjusted) deficits, and the legal enforcement mechanisms were weakened so as to make it easier for Member States to block recommendations by the Commission for sanctions (Watt 2005). Neither before nor since this reform have any of the foreseen sanctions been successfully imposed by European on national public authorities.

Less in the public eye, the Maastricht Treaty (1993) saw the introduction of the Broad Economic Policy Guidelines (BEPGs) as the instrument charged with realising the new treaty injunction that Member States 'regard their economic policies as a matter of common concern and coordinate them within the EU Council'. Briefly (for details see Watt 2001: 240ff.) the BEPGs established a loose surveillance and reporting procedure whereby the Commission makes annual recommendations to member states[1] based on an evaluation exercise against a number of common guidelines. Member States report annually on their progress towards meeting the policy recommendations. Though sanctions can, in principle, be applied here too (with Council approval), the process never went beyond a formal warning (in the case of Ireland in 2000; Watt 2001: 244ff.).

In 1997 the Amsterdam Treaty extended the same basic approach to employment policy with the introduction of the employment guidelines under the so-called European Employment Strategy (Watt 2004). The employment guidelines were, however, formally subordinate to the BEPGs and no sanctions for non-compliance were envisaged. This so-

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[1] From 1993 to 1998 the recommendations were made to the Member States as a whole; coordination was strengthened in 1999 with the incorporation of much more detailed country-specific policy prescriptions.

called 'open method of coordination (OMC)' was then employed under the Lisbon Strategy to provide a loose framework for coordinating a broad range of social, labour market, educational and other policies. However, there was little evidence that, beyond providing some useful mutual learning opportunities, the Lisbon Strategy succeeded in noticeably moulding Member State policy choices along the lines of an effort to achieve Europe-wide targets. In the case of the Lisbon Strategy there was in any case – and in marked contrast to the core economic policy areas such as fiscal policy – little basis for the belief that the policy spillovers between countries were really so significant as to warrant far-reaching attempts at coordination.

Further still from the public gaze, the Macroeconomic Dialogue was established (Koll 2005, Watt 2005a) in 1999, since when it has brought together representatives of European employers and trade unions (the 'social partners') with the European Central Bank, the Commission and two Council committees. The aim of the meetings held in this context is to facilitate an exchange of information intended to help ensure mutually supportive interaction, conducive to non-inflationary growth, between wage developments and monetary, fiscal and structural policies. The meetings are purely advisory in nature, confidential, and do not constrain the actors in their behaviour.

This very cursory thumbnail sketch describes the state of economic governance – that is, the institutions and procedures to ensure coherent economic policymaking in Europe – that was in place in late 2008 when the global economic crisis hit Europe. In the preceding years, Europe's economic performance had been – at best – mixed.

There were certainly overall improvements in terms of unemployment and the fiscal position since the 'dark days' of the mid-1990s: indeed a number of (smaller) countries had actually achieved something close to full employment. The eastern enlargement of the EU had set in train a slow but steady upward convergence process of incomes. A number of countries on the 'periphery' of the EMU also enjoyed rapid catch up: Ireland, in particular and earlier, but also Spain and Greece once EMU membership was assured and interest rates fell sharply, reported strong growth and sharp falls in unemployment (from high initial levels). Inflation – the ECB's primary target according to the Treaty and its sole goal according to the central bank's own interpretation – remained low throughout Europe (Horn 2003).

Yet overall economic growth was rather disappointing, especially in the large 'core' economies of western Europe where unemployment remained high. The rate of productivity growth declined, and the Lisbon goals – which were tantamount to catching up with and overtaking the United States on key indicators – became an embarrassment. Worryingly, large imbalances opened up, especially within EMU, with some countries, especially Germany, recording huge external surpluses, while many others (the 'peripheral countries' just mentioned, but also, outside EMU, the UK and some eastern European countries) posted large and growing current account deficits. On the social front, most countries saw rising inequality, while employment growth was in many cases characterised by the relentless spread of atypical contracts.

Then the crisis hit.

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[2] Obviously, financial markets played an important role in the crisis and there has been much debate on how to reform them. Due to space constraints I exclude them from this analysis. See for instance Kapoor 2010 and a number of the contributions to Watt/Botsch 2010.

THE LESSONS OF THE ECONOMIC CRISIS AND REFORM NEEDS

The crisis, with its disastrous impact on output, employment and government budgets, blew away any complacency about the 'fitness' of Europe's economic governance regime. It created both a need, and also a political opportunity, to reflect on what we have learnt from the experience of ten years of EMU and to draw out the implications of the economic and financial crisis regarding the way Europe's economies, and the European economy as a whole, are managed. I would argue that the following eight lessons – there are certainly others[2] – are crucial:

- Annual government deficits, even structurally adjusted, are a bad guide as to how a country is performing and whether it is acting appropriately in view of the needs of EU partners. This is most clearly shown by the cases of Ireland and Spain which never broke the SGP rules and before the crisis were posting budget surpluses. The same is true of government debt levels. Consequently, simplistic quantified fiscal targets are not helpful. At the same time, the stance of the private sector (businesses and households), and in particular its debt position, disregarded by European surveillance mechanisms until now, is an important policy consideration. The positions of the public and private sectors must be examined together.

- Even within a monetary union, large and persistent current account surpluses and deficits are dangerous and yet they are systematically promoted by the existence of vicious and virtuous circles within a monetary union for, respectively, fast-growing/high-inflation and sluggish/low-inflation countries (the so-called real-interest-rate channel) (Allsopp/Watt 2003). These are not offset by changes in international competitiveness (trade channel) to the extent that many had envisaged. Consequently, coordination mechanisms to ensure appropriate unit labour cost and price developments are needed.

- Strong automatic stabilisers and discretionary counter-cyclical fiscal policy are needed both to address asymmetric shocks and to support monetary policy in countering area-wide booms and busts.

- The fiscal policy spillovers between countries are not just 'negative' (deficits in one country push up interest rates for everyone) but also 'positive' (expansionary fiscal policy boosts demand in other countries). This suggests a need to coordinate fiscal expansions in a bust (and not just fiscal consolidation in a boom).

- Tax competition undermines the basis for government revenues and increases inequality.

- Punitive sanctions, as envisioned under the SGP and BEPGs, cannot be imposed on countries that are in economic difficulty. Instead, such countries require the solidarity of other E(M)U members in order to protect individual countries from destabilising speculation and to prevent contagion effects. This requires facilities for some fiscal transfers between countries, arguably permanently, and certainly the existence of a standing crisis resolution mechanism that can be activated at short notice.

- Monetary policy sometimes needs the support of coordinated fiscal policy (for instance when it is at the so-called zero

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[3] It seems that Chancellor Merkel and President Sarkozy have already 'decided' that the reverse voting procedure, discussed below, is not acceptable; it is therefore highly unlikely to be adopted. See

[4] See

[5] See

bound when nominal interest rates cannot fall any further and the central bank faces difficulty in stimulating a moribund economy), and the reverse is also true (for example when indebted countries face high interest rates on public debt).

- Last but not least, a myopic focus on micromanaging consumer price inflation is not always an appropriate overriding rule for monetary policy.

PROPOSALS FROM THE COMMISSION AND COUNCIL

Since the start of 2010 two parallel processes have been set in train at EU level to bring about economic governance reforms. Both are supposed to be embedded in a broader strategy, known as EU2020, which is the successor to the Lisbon Strategy mentioned above (Pochet 2010). The first is a Taskforce reporting directly to the President of the European Council, von Rompuy, dominated by the Member States (specifically: by their finance ministers). The second is led by the European Commission. One can safely assume that the broad thrust of these proposals will be similar, although differences relating to the respective powers of Commission and Member States are on the cards.[3] As the taskforce report is not available at the time of writing – it is due to be discussed by the European Council at the end of October – this analysis focuses on the proposals from the European Commission.

The Commission issued two (non-binding) Communications on 12 May and 30 June 2010[4]. Then, at the end of September, it presented draft legislation[5] which will be presented for adoption to both the European Parliament and the European Council. The proposals, if accepted, would mark the biggest reform of economic governance in Europe since the start of monetary union. They can be summarised in three points:

- The surveillance of fiscal policy under the SGP is reinforced further, notably by insisting on the respect of the debt criterion (60% of GDP) or a rapid pace of downward adjustment towards it (one twentieth of the gap between the current and target levels per year). The medium-term objective (MTO) of being 'close to balance or in surplus' is retained, but this is now specified to be achieved by focusing on government spending rather than revenues. The sanctions regime is tightened, with a more graduated range of sanctions (deposits, fines, blocked access to structural funds). This is coupled with a measure (the so-called reverse voting mechanism) that makes it harder for member states to block a Commission recommendation to impose sanctions; the Commission's recommendation, rather than having to be approved by a qualified majority in the Council, would stand unless rejected by such a majority.

- The surveillance of member states is also to be broadened, notably by incorporating an assessment of competitiveness and current account positions against a 'scoreboard' of relevant indicators. Modelled on the excessive deficit procedure in the SGP, an excessive macroeconomic imbalances procedure is to be instituted, which leads to country-specific recommendations by the Commission. If ignored, these can also result in financial sanctions imposed by the Council.

- The coordination processes are to be streamlined in a new annual procedure known as the European semester. As this has already been adopted by the Council, it is not, strictly speaking, part of the legislative package, but it is nonetheless an integral part of the reform.

ASSESSING THE REFORM PROPOSALS

Let us start with two areas in which the reform proposals mark a step forward. In substantive terms, the issue of macroeconomic imbalances is recognised as being of key importance for a coherent and sustainable economic strategy in Europe; and a procedure for assessing and, ultimately, correcting them has been established. At the procedural level, the European semester promises to intensify the degree of policy coordination in Europe by establishing a common policymaking framework and timetable. In itself this is welcome: running through the lessons of the previous section is the conclusion that greater policy integration and coordination is needed. Taken together, these are important steps towards the needed coordination of economic policymaking in Europe and should not be belittled. However, they are not enough to outweigh what is bad about and what is missing from the proposals.

The centrepiece of the reform is a heightened focus on fiscal consolidation. Something akin to Germany's 'debt brake' (*Schuldenbremse*) is to be instituted across Europe. This is bad for a number of reasons. Excessive fiscal profligacy was not a cause of the crisis, and is really a critical problem only in Greece (and even there on the revenue rather than the spending side). High fiscal deficits and debt are the *result* of the crisis – inevitable and indeed desirable. While it is certainly desirable that they should be reduced, it is completely wrong to focus what is supposed to be a long-term reform of economic governance mechanisms on a single (and medium-term) policy requirement. Moreover, in the shorter run, if the injunction to reduce structural deficits by 0.5 percentage points (p.p.) a year and government debts by an average of around 1 p.p. a year – indeed twice that in some countries – is taken seriously, the European economy will suffer a 'lost decade', if not worse. In such a context, the new sanctions will not be worth the paper they are written on; they will be inoperable.

The proposed focus on the spending rather than the revenue side is unjustified, not least in the light of the problem of tax competition which the proposals completely fail to address. The recommendation, if followed, will lead to a steadily declining relative size of the public sector. Yet, this and, more generally, the mix of measures on the expenditure and revenue side, can be decided only by democratically legitimated (national) parliaments and not by an unelected bureaucracy. This is a recipe for conflict between member states and the Commission that the latter cannot win, even under the proposed new voting procedures (cf. De Grauwe 2010).

Then there are two important sins of omission regarding fiscal policy. No attempt is made when calculating deficits to allow for public investment spending that raises potential growth rates and thus promotes, in the medium run, fiscal consolidation. (Imagine an investor who cannot distinguish between two otherwise identical firms, one of which invests €10 million in the latest production machinery, the other the same sum in buying the CEO a yacht or a private jet.) Governments facing political strictures to cut deficits and debt will slash public investment, as this is easier and quicker than reducing statutory entitlements: this is what happened in the run-up to EMU in many countries. It is entirely unjustified by any sensible economic theory, and completely incompatible with promoting the goals of the EU2020 strategy[6]. Similarly, no measures to incentivise countries to strengthen their automatic stabilisers are envisioned, although there is a clear European value-added to such coordinated efforts which would make a major contribution to stabilising demand and output (Watt 2010).

More fundamentally, the close-to-balance rule, however sensible it may appear at first sight, has implications that are not always benign and can, under realistic conditions, be highly damaging. First of all, it implies zero government debt in the longer term. There is no sound economic reason why that should be regarded as optimal, and no government of an advanced country has, since the dawn of capitalism, come even close to running repeated budget surpluses and becoming debt-free. Moreover, adhering to such a rule forces the two other sectors, the private sector and the external balance, to precisely offset each other.[7] Given a balanced budget, if desired national savings are higher (lower) than investment, then the current account will be in surplus (deficit) to precisely the same degree. This – though it may seem counter-intuitive from the point of view of an individual – is why it can actually be sensible for governments to post repeated (but sustainable) deficits year-in, year-out: it mops up excess domestic savings without the spillover of persistent current account surpluses.

This brings us back to external imbalances, recognition of the importance of which I praised earlier. The problem is that, because of this interaction between sectoral balances – which reflects an accounting identity and is thus an inescapable 'fact of life' – the reform proposals are actually likely to prove incoherent. Unless the private sector changes its behaviour, insisting on balanced budgets will result in permanent current account surpluses or deficits that are likely to be seen as problematic under the excessive imbalances procedure.

Although the macro imbalances part of the proposals constitutes an important step forward, concerns remain even here. One is language that repeatedly implies that current account deficits are worse than surpluses, rather than their counterparts, and that adjustment is the sole responsibility of deficit countries. Another relates to the measures foreseen. The proposed scoreboard is ill-defined and risks making a mistake opposite to that entailed in the simplistic fiscal targets, namely, being open to any number of interpretations. It is cause for concern that the entire process appears to be based on an interaction between the European Commission (read: DG Ecfin) and national governments (read: finance ministries) whereas key to competitive imbalances are wage and price developments, and thus labour markets and collective bargaining institutions. These are the responsibility of other actors, and yet there is no indication of how they are to be incorporated. It seems that policymakers are sticking to the faith that, given enough 'structural reform', wage and price settings will become so 'flexible' that adjustment will be achieved via competitive pressures. The most benign interpretation of this is that it is the triumph of hope over the experience of ten years of EMU.

So far, we have considered missing elements within policy areas actually addressed by the reform proposals. Given that the legislative proposals are touted as a reform of economic governance, it is somewhat surprising that there should be no mention whatsoever of the role of monetary policy within the broader economic governance framework. The ECB was seemingly created in some secular version of the 'immaculate conception', and as such, the crisis has no

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6 Perversely, there is one exception to this logic (or rather illogic): countries that use tax subsidies to promote capital-funded pension schemes are to be permitted to set such spending against their deficits. In contrast to, say, investment in R&D or smart energy infrastructure, it is very dubious whether such spending can sensibly be regarded as an investment. See

7 This is because of a basic accounting identity that says that the government budget deficit plus any private-sector (savings over investment) deficit must be offset by an import of capital from abroad and thus a current account deficit. So if the budget deficit is zero then the current account is in deficit precisely to the extent that private sector borrowing exceeds its saving.

implications for its conduct. Yet this is obviously incorrect. The focus on fine-tuning inflation by the world's leading central banks did not prevent the second-largest crisis of capitalism, recently estimated to have cost the equivalent of at least one entire year's global output. And we now have a situation where the ECB lends money to banks for virtually nothing. The said banks lend it to national governments at up to eight percent and this debt has to be serviced by hard-pressed tax payers. Banks are able to pocket the difference entirely risk free, because the ECB then takes the bonds they have purchased as collateral for further free bank-loans, after which these super profits are distributed to shareholders and executives in the form of dividends and bonuses. The ECB cannot simply be treated as sacrosanct.

To sum up this assessment: while marking progress in some important areas, the proposals are a step backward in others and, above all, a missed opportunity to use the crisis to make changes that would enhance growth and employment opportunities in Europe and raise the welfare of European citizens. At heart the reforms mark an intensification of a long-standing – but evidently unjustified and unhealthy – obsession with fiscal deficits and debt, plus a basically sensible, and yet flawed, extension to macroeconomic imbalances. Meanwhile, matters urgently requiring reform are simply not addressed. In short, the European authorities appear not to have learnt the lessons from crisis, as set out above.

Criticising the package is not just a mater of identifying a lack of ambition. An ideal governance system can clearly not be created overnight. Criticism of the proposals must be sensitive to many real-world legal and political obstacles (notably the hard-to-revise European Treaty). Yet the weaknesses go far beyond caution and the proposals actually risk taking us *away* from that ideal. More worryingly, in the short to medium run, given the state of public finances and of the economy, the combination of the good, the bad and the missing could potentially prove very ugly. If accepted in their current form, the proposals carry a high risk of perpetuating economic stagnation in Europe, torpedoing the EU2020 strategy and leading to tensions and conflicts that will lead to political disintegration rather than the needed integration.

TOWARDS ALTERNATIVES

What changes to the economic governance reform proposals would produce better economic outcomes for Europe's citizens in the years ahead? Clearly we cannot simply go back to the drawing board and design a whole new architecture. The concluding paragraphs indicate some possible pathways towards more effective economic governance in Europe. Some are of a more technical nature and could be easily incorporated into the existing proposals. Others, while more far-reaching, could nonetheless be achieved given the appropriate political will on the part of the relevant actors.[8]

An obvious starting point is to change the balance between fiscal and macroeconomic surveillance. The sensible solution is to focus primarily on the external (i.e. current account) balances, which have been shown by the crisis to make countries so vulnerable, and, *as part of that*, to examine fiscal positions, rather than to prioritise the public over the private sector (im) balance. In other words, the debt position of the public *and* private sectors (which together are equal and opposite to the current account position) of each country should be examined *in equal measure, at the same time and in a single*

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[8] For a collection of progressive policy proposals for Europe 'After the crisis', see Watt/Botsch 2010.

procedure. The unsustainable position of countries such as Spain and Ireland, despite their budget surpluses and low government debt, would thus have been readily identified. Such an examination would quickly reveal that, in most countries most of the time, it is changes in private savings and investment behaviour, rather than the behaviour of governments, that are the prime source of imbalances. What is more – and this is of greater immediate importance in policy terms – such an approach would foster Europe's economic recovery by leading to sensible policy recommendations, notably that countries with large surpluses on current account (above all Germany) should continue with stimulus measures, while deficit countries should consolidate earlier. To this end, the scoreboard idea should be developed further. It should not simply flash green or red but should permit a balanced appreciation of the state of the economy in question and of whether policies are such that the country can be considered to be treating economic policy as a matter of common European interest. Other actors than governments should be incorporated at national level (see below).

Within this altered assessment framework, what could be sensible guidelines for fiscal policy? Ideally, Europe needs mechanisms for establishing the desired aggregate fiscal stance given the expected economic situation. Then the appropriate 'allocation' of national fiscal positions, such as to take account of national and the overall European requirements and in particular the private sector (im) balances, would be made so as to arrive at the desired aggregate stance. Clearly, given what was said above about the endogeneity of the fiscal position, this could be no more than indicative. European-level coercion can refer only to the implementation (or failure to implement) discretionary measures, never to fiscal outturns which are driven by too many factors. Some provision for (limited) fiscal transfers between countries would be desirable. Agreement is needed on a definition of *additional* investment-spending that raises growth potential (or contributes to certain EU2020 goals); such spending increases should be excluded from deficit calculations. A simple first step would be to exclude countries' co-financing of (an expanded program of) lending by the European Investment Bank from consideration.

Clearly, such a 'rational' approach to coordinated fiscal-policymaking is a tall order, but the establishment of the European semester does, in principle, render progress towards this goal feasible. For both the macroeconomic and fiscal surveillance processes a much more nuanced set of 'sticks and carrots', positive and negative sanctions, needs to be developed in agreement between the member states (Council) and the Commission; for instance Manasse (2007) proposes a bonus/malus points system. Member States must want policy coordination; they should not be bludgeoned into it. This requires changes in content but also in processes.

These measures at the national level would need to be supplemented with European-level arrangements that, in particular, effectively limit undesirable tax competition (poaching revenues from taxes on mobile production factors) and provide European funding for needed public investment projects, notably in infrastructure and the transition to a green economy. These goals form part of the EU2020 strategy, albeit without explicit mechanisms.

Importantly, the surveillance and policymaking activities cannot be left to the Commission and Member State governments alone. Particularly with respect to wage- and price-setting, which is crucial for the whole idea of monitoring macroeconomic imbalances, the social partners need to be incorporated at both the European and the national level. An obvious way to achieve this is to strengthen the existing Macroeconomic Dialogue (MED) at European level and ensure its better articulation with national-level social dialogue processes and institutions (Koll/Hallwirth 2010). The former should become a permanent secretariat rather than a series of ad hoc discussion meetings. Tripartite institutions to liaise with the EU MED – such as already exist at technical level in Germany – should be established. Meanwhile, trade unions should seek to develop further their autonomous attempts to bring about a greater coordination of wage-setting; in this, they should receive support from the public authorities. More generally, collective bargaining institutions at national level must be strengthened. This is a prerequisite for (nominal) wage-setting to take macroeconomic considerations into account.

Finally it is vital to bring monetary policy into a genuine European economic governance. Inflation targeting could be supplemented by more explicit mandates to consider financial stability, growth and employment, requiring additional monetary policy tools (Palley 2010). The looting of taxpayers by banks, with the ECB as accomplice, could be stopped overnight if the ECB extended credit to national governments (directly or indirectly through some more permanent support scheme: an example is the Blue Bond proposal, see Delpla/von Weizsäcker 2010). Various conditions would need to be imposed on such monetisation in order to avoid moral hazard; governments spending recklessly and then waiting for an ECB bail-out. For instance it could be linked to additional spending on certain forms of investment. As the crisis has shown, the ECB has in fact considerable scope to define its mandate as it sees fit. Treaty changes would not be absolutely necessary (albeit probably desirable) provided the ECB were willing to become a cooperative partner in a wider system of economic governance that would serve the needs of all Europe's citizens.

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