Area: Europe / International Economy & Trade
ARI 71/2010
Date: 20/4/2010

New Changes and Old Challenges in the Economic Governance of the Eurozone (ARI)

Clara Crespo[*]

Theme[1]: The tenth anniversary of the creation of the euro coincided with the most severe economic crisis since the Great Depression of the 1930s. And it did so amid uncertainty over the ratification of the Lisbon Treaty. Its entry into force will allow for some improvements, such as greater economic coordination, but some of its weaknesses will remain. Despite this, as a whole the eurozone will probably emerge strengthened from the crisis.

Summary: This article analyses criticisms and proposals for improved European economic governance, including those that remain up for debate after these ten years, those which will probably be applied following the entry in force of the Lisbon Treaty, and those which might arise as a result of the crisis. The crisis has focused much interest on the following two questions: who ser ves as the voice of the euro in the world, and which countries are going to join the eurozone and which ones are to be left out. We will address these two issues first, then the three traditional pillars of EU economic policy (monetary, fiscal and supply policy), and finish with a section on changes in the distribution of power caused by the crisis and the Lisbon Treaty.

Analysis:

External representation of the eurozone

One weakness of the eurozone economic governance which became clear during the crisis is that of its external representation in the world. This field includes on one hand communication on the euro's exchange rate against the world's major currencies and, on the other, the unity of discourse from the euro area countries in international fora such as the IMF, the World Bank and, especially now, the G20.

Communication on the euro's exchange rate corresponds to the Ecofin meeting of EU finance ministers, to the extent that it is the body with jurisdiction to decide on the value of the euro after consultation with the European Central Bank (so that such decisions do not jeopardise price stability). However, the Ecofin Council includes members that are not part of the Monetary Union. For this reason, the person in charge of external communication is not the six-month rotating President of the Council, nor the new permanent President of the Council, but the Chairman of the Eurogroup (the meeting of finance ministers of the eurozone), currently Jean-Claude Juncker, the Prime Minister of Luxembourg.

[*] *Qualified State Economist (Técnico Comercial y Economista del Estado).*

[1] This ARI was originally written as a chapter of the book 'Think Global - Act European II' devoted to the Spanish, Belgian and Hungarian Trio Presidency and focused on the changing role of the rotating Presidency and the trio itself. It was published by Notre Europe, Egmont, GKI and the Elcano Royal Institute.

This division of labour has its drawbacks. The political characteristics which make a good candidate for thejob of President of the Eurogroup (being from a small country in order to put other members at ease, and having a strong knowledge of economics at the technical level) are the same ones which weaken the international visibility of the euro's main spokesman. The result is that communication on the euro ends up being informally shared out with other people.

For instance, the words of the President of the European Central Bank, currently Jean-Claude Trichet, can be interpreted as indications as to the desired euro-dollar value, since in any case his decisions on monetary policy will affect that exchange rate, even though that is not his goal from a legal standpoint. Another person who could be the external voice on the exchange rate is the European Commissioner for Economic and Monetary affairs. However, being a collegial body, the members of the Commission must act in mutual agreement, and not all of the countries 'represented' on it (Commissioners are not supposed to represent their countries of origin in theory) use the euro. What is more, it is a post that lacks power to vary the euro-dollar exchange rates beyond what might result from public statements. as explained, the President of the Council or the rotating Presidency cannot fulfil this role either, since not all Council members are in the eurozone.

Therefore, anyone who expresses an opinion at a given time (it is often the President of France) may be interpreted as being a representative for the eurozone. This leads to confusion and repeated explanations to the public as to who really is qualified to speak on behalf of the entire zone.

Furthermore, the EU continues to debate how its external communications in international financial institutions or other fora, such as the G20, should be organised. The lack of agreement both at the EU and the eurozone level on a standard applicable to all cases affects the idea of a single seat at those institutions. It also affects the scope of common positions among countries, which historically have carried more weight in the international arena (and more contrasting positions) than they might do now, with the rise of the asian economies. In most concrete cases, member states are in fact capable of speaking with a single voice, but they do not want to commit to doing it as a general rule. They arrive at that single message in painfully slow agreement processes and the margin of manœuvre out of the negotiated common position is very narrow. Often, they concentrate more on achieving a common message than on the impact of that message on third players. When there is disagreement at the EU level, the common position leaves out the key issues (on which single member states take the floor), therefore becoming much less interesting.

Enlarging the eurozone

In times of financial turbulence, the advantages of having a strong currency become clearer. Denmark and Sweden are reconsidering their decision not to adopt the euro, and for the countries of Eastern Europe not yet using it, joining has become a top priority.

Membership rules are still the criteria of fiscal and nominal convergence set almost twenty years ago in the Maastricht Treaty. The Eurogroup has insisted several times that countries which want to join must fulfil these conditions. But it might be rational to revise them, not necessarily as a result of the crisis and the new member states' pressing needs, but because they are fairly outdated and have lost relevance from an economic viewpoint. The Maastricht criteria were designed in the 1990s, when the priority was to encourage fiscal restraint and force countries from outside the area of the German mark to adopt a strong-currency model.

The two criteria most subject to criticism are the monetary ones, which try to encourage strong-currency behaviour: inflation and the national currency are linked to the euro within bands for two years (something like purgatory). These criteria are irrelevant for very small and economically open countries, where only part of the economic activity is carried out in the local currency (and the rest in euros). In these countries, central banks do not have much control over economic variables, nor is it in their interest to invest political capital in building anti-inflation credibility, because their goal will never be to let their currencies float freely.

As it is usually the case, the problem with revising entry criteria is which ones to establish. They should serve to measure the economic health of a country. They should include (revised) fiscal and monetary criteria as well as other institutional requirements, such as, for example, transparency and good functioning of the statistics system of a country, as the case of Greece shows. The alternative, which does not seem feasible or desirable, would be to simply erase all membership criteria, and let in any country who wants to join.

The ECb and single monetary policy

Formally speaking, the only goal of the European Central Bank is price stability (the rest of the EU's goals, which include employment and growth, are secondary), so critics fear that it is biased against growth. Under the Lisbon Treaty, and despite resistance from the bank itself, the ECB has been moved from the category of 'other institutions' to that of 'EU institutions'. This means it is obliged to pursue all of the goals of the EU, including economic growth and employment. This is not a trivial change, from a legal standpoint. But it will probably not have major, real consequences because it has been shown empirically that the ECB already takes into account growth forecasts when it modifies exchange rates in order to ease excessive cyclical fluctuations. More specifically, several studies show that the ECB makes its decisions while keeping in mind the expected rate of inflation and the expected output gap.

However, it is true that the ECB acts more slowly and with less intensity in changing interest rates than does the US Federal Reserve. The minimum and maximum rates set by the Fed over the past ten years have been more extreme than those of the ECB, and the Fed tends to start a cycle of increases or decreases before the ECB does. One reason is that the European and american cycles are not perfectly synchronised, so their interest rates should not be either. Also, real markets in the eurozone itself are slower to react. It is for this reason that during the current crisis the ECB has been accused of lowering interest rates too slowly, especially after it became clear that the financial crisis had hit the real economy.

On the other hand, the bank has been praised for being swift in increasing liquidity and coordinating with the Fed. at this other extreme there is also worr y over the impact this huge increase in liquidity will have due to the 'open bar' policy (as much liquidity as demanded, at the monetar y policy interest rate, rather than setting a fixed rate at auctions).

Where the existing policy has clearly failed is in the prudent oversight and regulation of financial ser vices. Blame for this should go not so much to the ECB, which has no jurisdiction in this area, but rather to the member states, which were ignorant of what was happening.

Reforms proposed by the European Commission are based on a report issued in February 2009 by a special group headed by Jacques de Larosière. This group certified the failure of the weak European mechanism previously created to respond to financial crises. But all it recommended was creating a coordination mechanism among national governments for the purpose of prudential oversight. The mechanism suggested by Larosière, strictly EU-based, consists of a decentralised system formed by a European Systemic Risk Council (systemic risk is not addressed so far by any supervisory body), led by the ECB, and a European System of Financial Supervisors (a network that coordinates the national oversight bodies). The usefulness of this mechanism will depend on its capacity for making sure that its recommendations are taken into account; in other words, on whether it has teeth.

Fiscal policy and the single European bond

Economic policy in the eurozone comprises three uneven pillars: monetary policy, jurisdiction over which has been ceded to the EU; fiscal policy, which is coordinated; and supply or structural reform policy. In the latter, one can say there is no more than an exchange of information under some general common guidelines.

The Stability and Growth Pact coordinates fiscal policy with the understanding that, under normal conditions – and not in the abnormal situation of 2009–one must offset the tendency that governments have toward deficit spending because of their short life spans (the time between elections). Following the reform enacted in 2005, the Pact allows governments to register a budget deficit in times of recession, and encourages them to ensure a surplus in times of economic expansion. Otherwise, the fear is that some member state will engage in deficit spending constantly and, overall, issue too much debt. Other states would then be forced to rescue that government, also issuing debt to finance the operation (this is known as the bailout problem).

In order to avoid this, a common procedure has been established to oversee and issue opinions and recommendations on each member's fiscal policy. There are no incentives for encouraging compliance (above all, for posting a surplus during periods of growth), while there are sanctions (at least, theoretically) for profligate countries. Because of the crisis, the priority came to be fiscal expansion, as a result of which most governments found themselves in the red. The Commission, which is tasked with proposing opinions and recommendations in this area, has gained influence, since its recommendations carry more legal weight when a country has registered an excessive deficit than when its budget deficit is less than 3% of GDP. It is, in fact, more influential in bad economic times than in good ones.

The result is that the fiscal exit strategy from the crisis has been designed at the EU level somewhat fast: budgetary consolidations are to start in 2010 or 2011 at the latest; it is also agreed that the magnitude of the challenge requires fiscal efforts to be greater than the general rule of the Pact (which implies a structural adjustment of 0.5% of GDP per year). Finally, all member states must register a budget deficit below 3% before 2013-14 (depending on the initial position). In this sense, the design of an exit strategy has been swift. In the following three or four years we will see whether it was sufficiently credible.

Meanwhile, the crisis focuses the spotlight sharply on the bailout problem. The concern is that capital markets, sensing that some member states might decide to rescue others by issuing debt of their own, could demand higher yields from the debt issued by the 'rescuers'. In this way, countries with prudent fiscal policies would have to pay a higher cost to finance their debt, because they issued debt to save those who were imprudent. It is said that the clause in the Treaty which bans bailouts is not credible. But the key issue is that in practice financial aid, with the consequent issuing of debt, comes before a state declares itself bankrupt, as was the case with the aid granted to Hungary and Latvia. Much remains to be seen in the case of Greece. Being a eurozone member, it cannot receive that existent kind of aid, but it could always receive another new type. at the same time, its government can be subjected to much greater peer pressure by the rest of the Eurogroup, forcing it to apply certain economic policies.

Finally, one could look at the proposed issuance of a single European bond. In the event that some member state is on the verge of collapse, and the political decision to rescue it is taken, all the other countries should get involved, out of solidarity and because the externalities of the fall would affect everyone. To confront the cost of a bailout, one possibility would be to issue a single European bond, to which each member state would commit in line with negotiations held beforehand. Another issue is how the markets would digest the issuance of that bond in the current situation. It might also be the case that, at this particular time of high issuance, national treasuries do not want a European bond to enter as another competitor.

Structural reform policy

The customary mantra for the eurozone says that the absence of independent monetary and exchange rate policies requires firm application of structural reforms, mainly in the labour and services markets (including today financial markets), but also in retirement pensions, education and many other areas, so as to achieve adjustment to unsynchronised business cycles via wages and prices instead of employment and output. Flexibility in these markets will lead to a better functioning of the monetary area. The crisis may serve as a learning experience in each country to drive reforms, regardless of the incentives that the EU procedure seeks to offer. On top of that, during the Spanish Presidency of the EU (first half of 2010) the EU is reforming its Lisbon Strategy in what is to become the EU-2020 Strategy. But those are areas under the strict jurisdiction of member states, where the EU can only seek to provide incentives and create political momentum for reform.

Under the Lisbon Strategy, the EU established a multilateral oversight procedure similar to that of the Stability Pact: each member state drafted a programme (Stability Programme in the case of fiscal policy; a National Reform Programme in the case of structural reform policy) that presented its plans, in accordance with common lines agreed in the EU, and a year later the European Commission and the Council gave their opinion on whether the government had lived up to its commitments. However, this procedure did not play a useful role in establishing incentives for governments to implement the necessary reforms.

This is due in part to the fact that the Lisbon Strategy procedure had less legal force than the Stability Pact. This asymmetry has been addressed with the Lisbon Treaty, which gives the Commission powers in the former, equalling its power to that in the domain of fiscal policy (the right to present proposals and to make direct warnings).

But symmetry in the legal power of the procedures is not the main issue. The force of EU initiatives in areas that fall under member states jurisdiction depends on establishing a mechanism that is so visible and widely accepted that failure of compliance leads to significant political cost for individual governments. If governments feel that there is a reward from voters for compliance, the mechanism would be even better. What the EU-2020 Strategy will try to address is visibility of the Brussels-based examination, with the objective of creating the correct incentives for structural reform in member states.

The distribution of power

Distribution of power among institutions and member states is the reason why summits stretch past midnight and the reason why EU issues are obscure to the layman not versed in them. In the area of economic policy, to speak of the distribution of power is to speak, on the one hand, of the distribution of power among the Commission, the Council and the European Parliament; on the other hand, the power of the 'ins' as opposed to that of the 'outs' in the Council (in other words, the power of the Eurogroup (ministers of the eurozone) as compared to that of the Ecofin (all member states).

Under the Lisbon Treaty, the Parliament gains power vis-à-vis the other two institutions, since it becomes involved in several legislative procedures. In this sense, both the Council and the Commission lose some freedom, since they need to take the Parliament into account. at the same time, the Commission probably gains more leeway both in the fiscal policy (as a result of the dire fiscal situation its recommendations gain legal force) and in structural reform policies vis-à-vis the Council. In this last area, the Commission definitely gains power on a legal basis: its rights are symmetrical now to its rights in fiscal policy and some articles are added in the Treaty which can be a legal basis for more economic coordination, depending on the content that the Commission wants to give them. But its effect in practical terms remains to be seen.

With regard to the second issue, the Lisbon Treaty increases the power of the 'ins' versus that of the 'outs'. Since it was created, the Eurogroup has seen its weight and influence increase, even though it is not a formal part of the EU institutional grid. The Lisbon Treaty acknowledges its existence with typical EU acrobatics: its meetings continue to be informal, but in those cases in which the Ecofin addresses issues which only affect members of the eurozone, non-members will not vote, if there is a vote. What this system actually does is prop up the status quo. These days, since meetings of the Eurogroup precede those of the Ecofin, issues that are dealt with in the former are presented as fait accompli to the Ecofin ministers. There, these issues can be debated again because it is the Ecofin which has formal decision-making power. But there are usually few changes. The paradigmatic example is that of application of convergence criteria for examining the entry of a new member into the eurozone. This is an issue which the countries of Eastern Europe would like to address in the Ecofin meeting, but the members of the Eurogroup arrive with their decisions already made.

The leadership shown by eurozone members with the meeting held on Sunday, 12 October 2008 has deepened this panorama even more. That meeting, convened by the French President, Nicolas Sarkozy, which then held the rotating EU Presidency, after the fall of Lehman Brothers, approved an action plan against the crisis which was later endorsed by all 27 member states.

Another effect of the greater power of the Eurogroup is that those who gain the most proportionally are the big member states of the eurozone; in other words, after the new voting rules in the Lisbon Treaty come into effect, Germany will formally consolidate its power over the rest, followed by France and Italy. In the Eurogroup formation, the right to vote is suspended for countries which do not belong to the eurozone. So the weight of the large countries is relatively larger, and a small loss of power in the Ecofin is magnified in a smaller setting such as the Eurogroup. Of course, in actual practice the power of each country also depends on the effectiveness of their foreign service, and in this area United Kingdom and France are in one class and everyone else in another.

Conclusion: The crisis that began in July 2007 opens up new scenarios in the balance of power, both between institutions and member states. The three pillars of economic policy in the eurozone once again change in dimension: monetary policy emerges strengthened, the goals of fiscal policy change and questions arise over whether the crisis will serve as a lesson to encourage structural reforms. But the biggest change is that the crisis has given more relevance to other aspects of eurozone governance, such as its enlargement and its external representation.

It has never been more necessary than now for the EU to speak with one voice in the international arena. What is at stake for Europe is shaping the institutions that emerge from the crisis. If it is not possible to take part in the international debate with one voice representing the entire EU, it is the voice of the eurozone that will come forth. And extrapolating from what has happened in the past few months, it is the one that will be heard the most.

Clara Crespo
Qualified State Economist (Técnico Comercial y Economista del Estado)