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Redefining European Economic Governance

Edited by
Michele Chang, Georg Menz and
Mitchell P. Smith

ROUTLEDGE

Redefining European Economic Governance

The global financial crisis and sovereign debt crisis exposed the inadequacy of European economic governance. Despite the multitude of new mechanisms and institutions that have arisen over the last few years, many contend that economic governance remains inadequate and the EU must integrate even further to calm still volatile markets. A tension exists between creating effective instruments that will not overstep the authority delegated to an EU that has integrated economically but not politically. Can the EU's economic governance system satisfy the demands of markets and politics? Relevant issues include the ability of supranational institutions to dictate policy to national governments, the harmonisation of economic policies and institutions across Europe, and a substantial increase in the transfer of funds across borders. Can monetary union continue without political union? How will the new institutions alter the distribution of power between EU institutions as well as between member states?

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This book was previously published as a special issue of the *Journal of European Integration*.

Michele Chang (College of Europe), **Georg Menz** (Goldsmiths University of London) and **Mitchell P. Smith** (University of Oklahoma) are former co-chairs of the European Union Studies Association's Political Economy Interest Section.

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INTRODUCTION

Kicking the Can Down the Road to More Europe? Salvaging the Euro and the Future of European Economic Governance

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Recent assessments of the nature of the eurozone's problems, their origins, and of policy choices and likely outcomes inform our understanding of the crisis and explain its persistence. These accounts detail weaknesses in design of economic and monetary union (EMU) and its implementation (Meyer 2010; Dadush and Stancil 2010; Cooley and Marimon 2011); the manner in which political constraints have limited or distorted policy choices (Scharpf 2011); and the failings of political leadership at both European and national levels (Featherstone 2011). But more or less lost in the welter of commentary is any account of how we identify and account for the trajectory of European economic governance in response to the eurozone's troubles.

Few observers of the single currency correctly predicted the extraordinary economic problems the euro has created for Europe: mass unemployment, depression, social unrest, and rule by technocratic government in southern Europe and billions of public funds diverted to sustain the speculative transactions of French and German banks with concomitant years of debt service for future generations in the North. If the economic instability caused by the euro were not serious enough, the political ramifications have been equally severe: an exchange of xenophobic stereotypes in the German and Greek press cast serious doubt on just how much pan-European sentiment the integration process has produced, while imposed austerity in southern Europe appears to nourish the emergence of far-right movements as in Greece, also strengthening separatism as in Spain.

As students of European integration we are intrigued by a currency upheld as a symbol of European integration that is purportedly worth saving at any cost and by the political implications of the recast architecture of European economic governance. While the prevailing narrative inscribes the euro crisis as one of irresponsible budgetary policy in southern Europe (Scharpf 2011), the official response strategy is one of making the Maastricht criteria stick, whilst marginalizing treaty provisions to allow the creation of well-funded vehicles that convey northern public funds to purchase largely worthless southern government bonds originally acquired by northern banks.

Economic governance — the set of institutions and mechanisms for ensuring the orderly pursuit of shared economic policy objectives — has in fact evolved at multiple levels, including policy processes, policy outcomes, and institutional dynamics. Collectively, these shifts amount to a redefinition of European economic governance consisting of an unlikely amalgam of diminished reliance on the 'Community method' characterized by European Commission agenda setting, along with a series of institutional innovations that strengthen common fiscal surveillance and oversight of macroeconomic imbalances and thereby advance integration. Institutionally, select nodes within the Council of Ministers — the permanent Council presidency and the Economics and Finance Council — have taken a firmer hand in agenda-setting; the actions of the European Central Bank have drawn national economic domains more directly into the European governance mix; and the European Parliament has sought to become a more active interlocutor of all of these actors as the voice of European citizens. Ironically, amidst the eurozone's severe strains, we are witnessing the emergence of a more 'European' European economic governance through unexpected means.

This trajectory provokes critical questions. How can we explain the form taken by institutional innovations? What role do existing EU institutional structures and policy inheritance play in determining the contours of these arrangements? How have institutional roles in the establishment of those mechanisms varied over time, and why? And what is the significance of the national economic divergence highlighted in much of the recent analysis of the eurozone crisis — not simply as outcome of the flaws in the design of EMU, as emphasized in the recent commentary — but as *cause* of policy patterns and decision processes?

In this issue, we assemble contributors who explore the dynamics of European economic governance in response to the ongoing troubles of the single currency, which are intertwined, of course, with the major global recession sparked by the collapse of trade in overvalued US home loans and the subsequent closer attention paid by international banks to the macroeconomic data of southern and northwestern European governments whose securities they had readily purchased in the early 2000s. Our common theme is an *institutional* focus that analyzes both *policy output* produced by European institutions in the wake of the crisis and the *dynamic interactions of these institutions* themselves. Consequently, several contributors employ historical institutionalist arguments about path dependency as a central element shaping policy choices, while others deploy the prism of a principal-agent framework to explain the evolution of European economic governance.

Through these approaches, the volume brightly illuminates the choice of institutional innovations. Elements of the EU treaties and existing institutional arrangements, choices and constraints appear to have been vital in shaping the overall response to the mounting eurozone banking and sovereign debt crisis. The response itself has hardly been either linear or inevitable. As observers have explained relentlessly, the Maastricht Treaty did not create sufficiently powerful corrective mechanisms (especially in the fiscal realm), yet also closed off policy options by placing restraints on actions (the prohibition on monetary financing of national governments, for example) and actors (ECB). Crisis resolution has as a consequence proven elusive. But our analysis cannot end there. These treaty components not only account for the casting about for politically acceptable and economically effective solutions throughout the crisis; these omissions and constraints also help us understand the course that *has* been taken by eurozone member state governments.

Of course, the very existence of prohibitions that produced policy paralysis pushes to the fore the question of incorporating into European economic governance an ultimate element of supranational executive discretion authorizing measures to salvage the eurozone in dire circumstances, creating once and for all a credible commitment to irreversibility of economic and monetary union. Kenneth Dyson carefully maps this terrain of 'supreme emergency' in his article, motivated by the insight that rules relying on the behaviour of markets and states are unlikely to operate as expected in crisis conditions. He establishes that any authority to invoke such a prerogative would have to be vested in an independent agent. Nonetheless, as Dyson informs us, this is inherently a normative question that, inevitably raised by the tensions inherent in European economic governance, inevitably will remain unresolved.

It is a widely accepted insight that European integration has often thrived on difficulty and proceeded because of and in spite of extremely adverse circumstances. A number of — very cautionary — regulatory attempts have been made to somewhat limit the awesome powers of financial markets, while EU actors have created rescue vehicles, crucially the European Stability Mechanism (ESM) and the European Financial Stabilisation Facility (EFSF). Critically, in the process of attempting to salvage the single currency new power dynamics have unfolded, with a decisive shift away from the 'community method' and a much more intergovernmentally inspired response pattern. Initially, of course, eurozone crisis response efforts adhered to the community method. This was true of the 'six-pack' of economic reforms proposed by the European Commission in fall 2010, which addressed tighter fiscal surveillance, oversight of macroeconomic imbalances, and strengthening of the Stability and Growth pact and followed traditions of Commission agenda-setting. But a change in the dynamics of policy making quickly ensued, as national governments actively sought to reduce agency slack accruing to supranational institutions, shifting agenda setting authority to the Council President and members of the Economics and Finance Council (Ecofin) and in essence established a hierarchy that subordinated the role of the Commission to these actors.

Such a shift towards what Angela Merkel describes as the 'Union method' is perhaps unsurprising given the substantial long-term financial commitments entered into by northern governments. However, the robust role that key national governments, especially the German, but also the French, have played in the process of elaborating a response, must not distract us from the noteworthy policy entrepreneurship of an institution that has quietly emerged from relative obscurity to being a major *eminence gris*. The European Central Bank (ECB) has been a crucial actor in helping usher in the institutional and practical foundations for fresh cash injections into the strapped governments of the South. The ECB is also playing a role in the enforcement of austerity programmes largely resembling Washington Consensus-style structural adjustment programmes in Greece. In the ongoing tug-of-war between the Commission and the member states, the response thus far seems ultimately more shaped by member state influence, the latter understandably keeping the rescue vehicles on a tight leash. However, broadly speaking, European-level influence in devising a response is hardly absent, notably in the form of both the enlarged ECB role and a very activist European Parliament (EP).

Rather than confining ourselves to one preferred approach or school, our contributors employ a variety of mid-level theoretical approaches, while all broadly subscribing to an institutional focus. All concur that the response seems to be geared towards affirming both the single currency and the Maastricht criteria with tougher enforcement mechanisms and imposed austerity and structural adjustment programmes meant to redress the mounting and persistent economic imbalances highlighted during the past few years. Whether such strategy is viable, as senior economists openly question, whether the euro has been salvaged once and for all given the obvious economic mismatch in terms of its membership basis and the severe dislocations this will continue to produce, and whether the response strategy has thus merely 'kicked the can down the road' are valid questions worth contemplating.

In their contribution to the volume, Jonathan Yiangou, Mícheál O'Keeffe and Gabriel Glöckler demonstrate how the monetary financing prohibition, by closing off one channel to the resolution of the eurozone crisis, pushed the process onto an alternative path. Consistent with the European Central Bank's independence and mandate to pursue price stability, the prohibition on financing of governments' debts was intended to protect monetary policy from the intrusion of a fiscal imperative generated by the budget positions of national governments. Both this group of authors and Nikos Zahariadis in his essay on the Greek debt crisis point out that the dynamics of fiscal federalism, according to which markets and voters were to hold individual governments accountable — through risk premia and electoral choice — did not function effectively. Costs of fiscal choices spilled across national borders. As contagion spread, the potential costs of eurozone disintegration rose sharply.

At this point, institutional constraints become critical to the course of EU economic governance. The ECB resisted any dramatic deviation from its mandate and limits. As Yiangou, O'Keeffe and Glöckler indicate, this impasse accounts for the shape of the first concrete efforts toward alleviating the crisis: restructured mechanisms to address macroeconomic imbalances; measures to assure sound national reporting of economic data; closer monitoring of peer fiscal policies, since financial assistance was to come in the form of fiscal transfers from other governments rather than monetary financing from the ECB; plans for centralized bank supervision and a framework for bank capitalization.

Initial economic governance choices made in the face of deteriorating conditions and diverse and uncertain preferences also have had lasting consequences for the subsequent course of European economic governance. Ledina Gocaj and Sophie Meunier establish that the creation of the European Financial Stability Facility (EFSF) in spring 2010 decisively shaped the permanent European Stability Mechanism (ESM) devised less than a delete second part of sentence 8 October 2012. The EFSF, to be available to governments cut off from capital markets, itself was hardly pre-determined; the institution was crafted in the context of near panic in financial markets, grave worries about domestic political constraints, and a wide range of conflicting views on how to respond effectively. In this environment, the EFSF emerged as a wholly inadequate instrument, as market and political forces quickly demonstrated. The response was a push from several quarters — from the ECB to national finance ministers — to expand the resources available to the EFSF. The apparent inadequacies of the EFSF structure and its intended temporary nature notwithstanding, time compression and the political dynamics of approval of any new bailout mechanism generated an ESM that was a modified version of the EFSF.

The decision of the Economics and Finance Council to create the EFSF represented an alternative to a European Commission proposal for an EU stabilization fund that would borrow on the strength of guarantees from member state governments. In this sense, as Meunier and Gocaj underscore, the form of the EFSF put economic governance decision making on a firmly intergovernmental path. Picking up on this very dynamic, Dermot Hodson explores the role of the Barroso Commissions, finding them a cautious player carefully safeguarding the institution's political capital and strategically supporting minimalist re-regulatory activity with substantial political support in the member states. The center-right political leaning of Commission President Barroso further contributes to an ultimately limited Commission-led response, effectively affirming the monetarist-inspired Maastricht criteria and avoiding substantial taming of the financial markets.

Michele Chang similarly investigates the weight of member states relative to the Commission, arguing that through the skilful appointment of constrained agents the member states maintain a key role in controlling the re-financing of southern government debt. Resonating with Chang's argument, while turning toward the external representation of the EU in institutions of global economic governance, Charlotte Rommerskirchen explores the incomplete Europeanization of representation of member states in international economic institutions, where despite some cautious delegation at the G-20, principals remain very restrained in employing agents and jealously safeguard their hold on interest representation in global fora.

Ironically, while Commission entrepreneurship appears to have waned in the crisis, at least in part due to divergence of national economic positions, national economic divergence and insufficient economic policy coordination have produced a very different institutional dynamic involving the European Central Bank. The operation of the ECB is based on delegation by the national governments to a completely independent agent, an act required to achieve credibility in the pursuit of price stability. Coupled with national economic divergence and the incomplete contracting characteristic of economic and monetary union, the process was likely from the start to require additional policy coordination. As indicated by Francisco Torres, soft policy mechanisms (such as the Lisbon Strategy) proved wholly inadequate to this purpose. The result has been the creation of a succession of new institutional mechanisms to advance the goal of stability amidst national economic divergence.

More precisely, the ECB has been driven by crisis into national policy domains in pursuit of its mission to provide stability 'in a highly fragmented political system' — and, critically, to protect its independence. Put differently, national economic policies become a matter of common concern as the ECB pursues its role as guardian of the objectives of economic and monetary union. This disjuncture between ECB independence and the production of new economic policy coordination mechanisms inevitably produces serious challenges for procedural legitimacy in the monetary policy realm.

What does this institutional constellation suggest about the likely sources of institutional innovation in European economic governance? As David Andrews explains in his comparison of the European Commission's 2008 assessment of successes and challenges confronting economic and monetary union after its first decade with its 1962 'Action Programme for the Second Stage' of the development of the Common Market, the Commission was quite insightful in its identification of the eurozone's problems at a relatively early stage, focusing on macroeconomic imbalances between countries and divergent developments in unit labour costs and competitiveness. Resonating with the 1962 action programme, the Commission also adhered to a general approach of long-standing: moving towards 'ever closer union' and a more European approach through embracing the principle of *engrenage*. All the more perplexing, then, is why the Commission was quite reserved as an entrepreneur initially in taking steps to rectify the obvious problems that emerged with the single currency during the second half of the 2000s in particular or why it hesitated to challenge the two heavyweights of the eurozone, France and Germany, in 2003 when both countries' macroeconomic data already diverged from the Maastricht criteria. As Dermot Hodson might suggest, entrepreneurial activity by the Commission seems to be heavily conditioned by strategic considerations — picking battles wisely — and the ideological orientation of the Barroso Commissions, as opposed to earlier Commission leadership which historically assumed a more technocratic stance.

Coinciding with Hodson's observation, Andrews finds that while a sort of 'bicycle theory' of the need for incessant forward movement of integration persists, the Commission has in contrast with its earlier incarnation abandoned an insistence that steps toward the breaking down of barriers between national markets — negative integration — must be accompanied by parallel developments in positive integration. Furthermore, the constancy of the Commission's conceptualization of the dynamic of the integration process suggests it is not likely to be a source of fresh thinking or innovative institutional reform.

National economic divergence provides one clue to the prominence of national governments in defining the emerging contours of EU economic governance. At the same time, such divergence may well be an impediment to efficient decision-making and effective outcomes. We see evidence for this, for example, in the manner in which the EU has translated financial rules negotiated in multilateral fora — such as the banking regulation agreed in the context of the Basel Committee on Banking Supervision in 2010 — into EU law. As David Howarth and Lucia Quaglia demonstrate, member state preferences shaped by structural features of national political economies, including the capital position and leverage ratios of banks and the nature of their financing arrangements, both reinforced the intergovernmental nature of the bargaining process and altered the application of the multilateral agreement in the EU context in ways likely to render it less effective.

National divergence also features prominently in Nikolaos Zahariadis's account of fiscal federalism, which draws on work by Hallerberg (2011) focused on three key disciplining factors to reign in spendthrift governments: market signals, a no bailout policy, and corrective action as well as an active populace punishing profligate governments in democratic elections. Hallerberg's argument suggests these conditions were met until mid-2009, but that bailouts developed in spring 2010 broke the link between national government finances and assessments of the sustainability of those finances by markets (Hallerberg 2011, 128). Zahariadis develops the argument for the Greek case, demonstrating that problems emerge when costs of fiscal choices are not confined to national borders, creating perverse incentives for individual governments to depart from the behaviour expected by market and political signals — and for collective deviation from adherence to the principles of fiscal federalism as well. At the systemic level — for the eurozone as a whole — problems are exacerbated where agreed fiscal limits cannot be met by most members, undermining the credibility of those limits. The spread of contagion across the eurozone rendered the cost of bailout potentially less than the cost of adhering to rules of fiscal federalism. Additionally, as Zahariadis points out, lack of adherence to principles of fiscal federalism has locked in structural inequalities by failing to impose adjustment on surplus and deficit countries alike, while efforts to rescue fiscal federalism have not made the threat of default any more credible.

Zahariadis' argument finds its counterpart in the analysis provided by Ramūnas Vilpišauskas, who underscores the formative role of popular sentiment in the member states in moulding the response to the crisis. In contrast with the analysis advanced by Howarth and Quaglia, Vilpišauskas places less emphasis on structural elements of national polities and more on preferences derived from domestic politics — illustrated, for example, in the divergent positions on a financial transactions tax backed by 11 countries and supported by the European Parliament. Vilpišauskas underscores the more intensive politicization of redistributive policies relative to regulatory policies, which in turn intensifies national divergence as a constraint on efforts to address the problems of the eurozone.

The response to the crisis of the euro has been uneven across both mechanisms and institutions. At the *EU level*, cautious and modest re-regulation has been passed, as detailed in Hodson's and Zahariadis' articles, though in no way does this limited tinkering with financial markets amount to the radical recast of the financial service industry seemingly demanded by the crisis since 2009. From a Commission previously known for its commitment to the neoliberal growth course articulated in the Lisbon Agenda, this was perhaps unrealistic to expect for both ideological reasons (Smith 2012) and political considerations.

An intriguing institutional re-arrangement points to three key findings of our analysis. *First*, rather than permitting facile generalizations about the response to economic turmoil in the eurozone being coloured by a supranational or an intergovernmental shade, the empirical and analytical reality is significantly more complex. As we document, the actions of member state governments and EU institutions have not simply followed the 'Community method'. The 'Union method' seems to be shaped significantly more by member states than might have been anticipated given the political constellations prior to the crisis. In truth, member state governments have been faced by an indecisive and uninspiring Commission, but they also hesitated to accept top-down Europeanization and a significant power shift to European-level institutions. In fact, one of the more interesting empirical phenomena is the ongoing power struggle between the German government, the Bundesbank and its representatives in the ECB and the rest of the central bank's apparatus. The struggle seems as much informed by disagreements over policy content as over the desirability of full fiscal union, with the 'German' argument reasonably highlighting the ignored dangers implicit in higher inflation, unsustainable and undesirable debt burdens, and massive wealth redistribution to a limited number of financial institutions. Thus, the somewhat muddled response is yet again a case of containing both strongly intergovernmental elements — the rescue vehicles in particular — and intergovernmental touches, notably in the form of the six-pack and the European semester. Ultimately, however, given the strong interest of the German government in securing and re-affirming the Maastricht criteria even this ostensibly supranational element is strongly coloured by one government's preferences.

Second, our analysis points to the emergence of two key actors, only one of which, the European Parliament, appears to have been the object of significant attention in the scholarly literature. The post-Lisbon ordinary legislative procedure enabled the EP to avoid Commission attempts to water down financial market re-regulation, asserting itself as a self-confident actor willing — and more importantly, able — to flex its muscles. A second pivotal actor, which deserves more scholarly scrutiny, is the ECB, which has engaged in extensive policy entrepreneurship. We detect a divided policy agenda here, with bank officials dedicated to not only salvaging the euro at any cost, but also pushing for fiscal union in the absence of unlimited lending or Eurobonds, effectively curtailed by the German Constitutional Court ruling of 12 September 2012. This agenda is not shared by all representatives in the governing council because of its obvious financial and political fall-out. The ECB can be said to have acted as a decisive, at times even shrewd actor in pursuing its favoured strategy. In fact, much of the empirical story reads like one of quiet, yet powerful, mission creep.

Third, our work points to the importance of delegation, its limits, its potential, and its implications for policy output and its legitimacy. The recently reawakened scholarly interest in applying the principal-agent framework to European studies bears testimony to the increasing significance of delegation as a governance tool at the EU level. A number of our contributors deploy this framework, exploring the often very tight room for manoeuvre afforded to the appointed agents. In politically sensitive and extremely costly affairs, principals are understandably conservative in allotting influence to the executing agents.

At the *national* level, the developments charted and analyzed here point to the familiar picture of the Franco–German alliance acting as an engine (or not) in European integration, with the October 2010 Deauville meeting between Angela Merkel and Nicolas Sarkozy, and their tentative bilateral deal imposing some of the costs of bailouts on private bond holders, a case in point. The proactive role of the Germans, not quite mirrored by developments in Paris, where a weak and confused leadership struggled to identify a coherent policy response and was ultimately replaced in national elections, is unsurprisingly linked to the financial responsibility implied by the current response strategy. Rapid and decisive action in 2010 was eschewed in favour of a piecemeal response to what were then portrayed as largely self-inflicted severe economic difficulties in one marginal southern member state. Events since have both highlighted the enormous financial cost of the initial dithering and hesitation, including that by German Chancellor Angela Merkel, at another singular historical moment.

Events at the national level also point to significant potential for political upheaval. It is worth highlighting the potential for government default on debts in Greece, as well as escalating political violence in the repression of anti-austerity demonstrations and the anti-immigrant tensions actively promoted by the Golden Dawn movement. Serious and sustained financial difficulties by both the Spanish governments and some of the autonomous regions, coupled with a vocal separatist movement not only in Catalonia and the Basque Country, along with mass youth employment provide all ingredients necessary for sustained political and economic turmoil. Meanwhile, in Italy as elsewhere in Mediterranean Europe, the consequences of a pronounced competitiveness gap with Germany, the inability to meaningfully compete in product markets with cheaper producers in East Asia, and the dire political consequences of extended austerity, at least for a government still wedded to liberal democracy and regular elections, are such that it has not been possible to entirely rule out a voluntary eurozone exit by any of the southern countries throughout the course of the crisis.

As if there was not enough uncertainty and potential for serious political conflict and civil unrest in the south, central European countries both within and outside the eurozone, such as Slovenia, Slovakia, and Hungary, are experiencing severe budgetary problems; Hungary is in addition witnessing the re-emergence of colourful populists with little more than a nominal commitment to the values of liberal democracy. Not only is it necessary to raise the question whether the can has been merely kicked down the road, it is also worth pondering why and in whose interest the kicking continues, given the hefty political and economic price tag for the ideological commitment to the desirability of a single currency.

Future academic work might chart the emergence of a consensus on the desirability of salvaging the euro and 'toughening up' of the Maastricht criteria amongst European elites as an ideational prerequisite for the course of action (cf. Heipertz & Verdun 2004). In an important update to her seminal monograph, McNamara wrote in 2006 (813–4):

> … a second key issue now that EMU is out in the open is whether we should look to the central bankers' consensus to provide an adequate foundation, or is consensus needed (but unlikely to be secured) across a broader range of political elites as well as their publics? … If the ECB is staffed by professionals largely educated and socialized along similar lines, consensus is relatively likely in the ECB as national policy traditions become less dominant over the past decades of monetary co-operation. Here the findings of a systematic sociological study of the ECB professional staff would be helpful to determine whether consensus is being reinforced by the new bureaucratization of the monetary policy realm and the creation of a professional socialization within the ranks.

We largely concur with these sentiments, but would add that for various and often pragmatic reasons, elite consensus stretches well beyond the narrow confines of the Eurotower in Frankfurt. In fact, despite the steep price associated with saving the euro, those policy makers expressing dissent in