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European Economic Government: the question is not when but how?

By **Jean-François Jamet**

Economist and lecturer at

Sciences Po Paris

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More

ABSTRACT

As the European economy dances on the edge of the abyss, economic policy is becoming increasingly federal in nature. However this has revealed a problem in that the latter is not based on any prior model and that it does not have the required political legitimacy. If we want European policies to make sense again we have to provide them with vital substance and have the courage to debate their content in public so that real European economic governance can emerge..

Never has the feeling that European leadership is missing been as clear and identifiable as now. The European Central Bank, which for a long time gave the impression that it was the only one able to reassure the markets and to defend the euro effectively, is undergoing full metamorphosis, with the departure of its chief economist Jürgen Stark (to the backdrop of internal disputes) and soon, its present president, Jean-Claude Trichet. Both France and Germany have shelved their differences in order to draw up joint proposals, but the slowness of the ratification of the decisions taken during the Eurozone Summit on 21st July last, shows how difficult it is to find consensus between all Member States. Elections that have taken place at successively close intervals have complicated matters further. José-Manuel Barroso, President of the European Commission, has tried to reposition the Commission at the centre of play but its credibility has now been eroded in the wake of a crisis, in which the inter-governmental approach has often won the day.

Europe is in fact facing a dilemma: the situation is such that there is great interdependence and major divergence, and there is no easy way to find a clear solution, which explains the extent of disagreement amongst economists and political experts. Generally centralisation is preferable when interdependence is high and divergence low. Conversely the decentralisation of competences is preferable when divergence is high without this leading to the creation of systemic risks. Ideally divergence should be reduced or a firewall against systemic risk should be created. But this takes time and it is difficult, notably due to political and institutional reasons – and also due to a lack of time in the event of a crisis.

The need for increased solidarity between Member States, given the dangers of insolvency on the part of banks and States, has led to a paradox. The eurozone is now in a race against time and is being rapidly forced towards greater budgetary union. But this is only being done out of necessity: integration is being imposed. Indeed it is being decided according to successive, last moment compromise agreements after long debate between Member States, with the latter mainly responding to growing investor disquiet. This process is not governed by any constitutional draft. The parliaments, and therefore the people, are mainly observing a fundamental change in what used to be called European economic "governance". The question of European economic governance is political in nature: given their inter-dependence and in spite of their divergence, are Europeans ready for a federal economic system? If the answer is yes, what shape should it take?

In answer to this we must first understand the cultural shock that it would cause in comparison with the system that the Union has been accustomed to, but which is no longer tenable. Then we have to accept that a public debt crisis necessarily also implies one of sovereignty. Finally we have to explain what a European economic government would be and highlight the ensuing politico-institutional obstacles.

1. The impossible statu quo

If there is one thing that we have learned from the crisis it is that the term "economic governance" is becoming obsolete. For a long time it was used to describe a weak coordination system that was preferred because it circumvented the issue of budgetary federalism, but increasingly it seems that it does not lead to reliable solutions. In all events, it is associated with the past.

What is European "economic governance"?

European economic governance consisted in a compromise between (i) the pooling of a limited number of competences, (ii) regulatory power through joint, negotiated rules and (iii) an invitation to coordinate policies that are still decided upon nationally. Centralised European competences covered either:

- "technical" subjects that supposed the establishment of an independent supranational authority (the European Central Bank in the case of monetary policy, the Court of Justice in terms of monitoring the implementation of EU law);
- or prerogatives, the pooling of which was directly implied by the single market (trade or competition policy);
- or redistributive policies for which the community budget – 1% of the Union's GDP – had a critical size (the Common Agricultural Policy and the Regional Policy).

The rules negotiated between the Member States, which prior to the crisis, were the second pillar of governance – were designed to guarantee the harmonisation of national rules and policies. The most technical regulations (for example in the field of consumer safety or healthcare), were the subject of European legislation, negotiated over several years, before a transnational, trans-partisan compromise was reached. Some rules were adopted regarding the budget in the eurozone to try and prevent the adoption of the single currency leading to lax budgetary policy nationally, with the implicit hypothesis that there would be greater budget solidarity in the event of difficulties. The problem with these rules was that contrary to technical regulations monitored by agencies or the national or European judges, their implementation was not monitored by an independent authority. There was only mutual political control within the Council.

This "weak" regulation thus resembled a third pillar of European governance: the coordination of national policies via non-binding rules or targets (for instance those set by the Lisbon Strategy with regard to competitiveness and employment, such as the aim of achieving a level of R&D spending equivalent to 3% of the GDP).

The Limits of the System: a Lack of Efficiency and Legitimacy

The crisis brought to light the weaknesses of this model, both from the point of view of its effectiveness and of its legitimacy. Given the recession and then the dangers of bank and sovereign insolvency, it was the European Central Bank that played the stabilising role. But to do this it had to go beyond its remit, for example by purchasing some of the debt of distressed States, notably to curb speculation over the Italian debt. Moreover the ECB is not a political body: it would not be able to implement a global strategy against the crisis alone. On the contrary the Member States' budgetary rules and economic coordination policies have lost all credibility, either because they were not applied, as for example, the budgetary rules of the Stability and Growth Pact, or because the corresponding institutional tools were poorly adapted to crisis situations (the community budget is not big enough to have any significant stimulus impact, since budgetary and fiscal decisions suppose the unanimity of the Member States and therefore long diplomatic negotiation), or because as far as the Lisbon Strategy was concerned, goals were simply set without the definition of any obligatory means. Hence the "weak", de-centralised part of the European economic policy contributed to political uncertainty and it even added a feeling of powerlessness to economic uncertainty. It also made the emergency drafting of a clear, credible joint strategy to the crisis impossible. In the face of the most serious recession since the Great Depression, Europe and its Member States have been incapable of speaking as one, and of agreeing on a relevant level of solidarity and mutual surveillance.

2. The Debt Crisis and the Sovereign Crisis

With the sovereign debt crisis it has become increasingly clear that the European Union and the eurozone have to make a choice. They either have to backpedal on economic integration and give up the euro, or push for greater budgetary integration by agreeing to limit national sovereignty from a budgetary point of view in exchange for greater solidarity.

The false solution of giving up the euro: an extraordinary economic and political risk

The first solution might seem attractive to stronger countries since it would make them feel that they would not be paying for mistakes made by others and that they would be free to define their own economic policy. However this solution is incredibly dangerous, both politically and economically. Firstly, for the weakest States who would be forced to default and to exit the eurozone. Their exit would inevitably lead to a major depreciation of their newly recovered national currency: undoubtedly this would help them recover growth by boosting exports, but many years would be required before they be back to pre-bankruptcy GDP levels. Moreover default would make painful social adjustments obligatory, in that these States would have to recover budgetary balance extremely quickly but without having access to funding from the market or from their European partners. The political cost of what would be considered as renunciation would be vast.

For stronger States, including those exterior to the eurozone, it is an illusion for them to think that they would not be affected if they left defaulting States to their fate. This is primarily because the entire banking system would be weakened and there would be the risk of a further banking crisis, and secondly because their exports to defaulting countries would decline significantly.

This logic has led Member States to accept greater budgetary integration. With the European Financial Stability Fund (EFSF), created in May 2010, the eurozone decided to provide those States that threatened to default with a new line of credit, thereby substituting private creditors to provide further loans. Access to funding has therefore been maintained for States that are in danger of defaulting, such as Greece, with the aim of giving them the necessary time to make structural reforms and reduce their deficit. But this might prove inadequate, in that austerity measures worsen the recession in these countries. A solution has to be found to reduce their debt immediately and/or support local investment, which inevitably supposes external aid together with austerity measures.

More seriously, contagion via the weakening of distressed States creditors, notably the European banks, or via financial speculation that affects countries like Italy, only increases existing risks. In this context the European Union, and more particularly the eurozone, are on the quest for a lender of last resort.

As for the role of the latter the EU can rely on the ECB, the IMF and the EFSF. However how the burden of the loan is to be shared between each of these institutions is a problem. A reciprocal guarantee system would undoubtedly enable the provision of greater resources and is under discussion at present: hence we might imagine that EFSF guaranteeing intervention by the ECB. Such technical solutions only provide an intermediary response however and are still subject to credible recapitalisation plans of the European banks and structural reforms that will enable the improvement of Member States' economic environment.

From the debt crisis to the restoration of European budgetary sovereignty

As far as Greece is concerned, various solutions are being explored, which are not mutually exclusive, but which each leave room for political reticence. The first solution would be to reduce the Greek debt in one go thanks to a vast privatisation plan[1] : Greek state assets would be brought together under one roof. These would be bought by a European institution funded by the Member States, which would allow Greece to reduce its debt to a significant degree immediately. The European institution which acquires the Greek State assets would then manage their gradual restructuring and privatisation. The difficulty of this exercise is that it would probably encounter fierce opposition in Greece, where political and social tension is already extremely high.

1. This proposal was made official in a document by the Roland Berger consultancy: Eureka project: Hellenic Recovery Fund, a solution for Greece and Europe, September 2011.

A second solution would be to put a Marshall Plan together for distressed States by funding investments, for example by way of European loans, in the shape of project bonds. Political reticence would come this time from Member States who refuse a "transfer Union" and who are sceptical about the ability of weaker countries to guarantee the effective use of these funds, since their governance systems are notoriously inadequate.

The partial cancellation of the Greek debt might prove to be inevitable as a last resort. The idea would be to organise the debt in such a way as to limit the impact on private and public creditors as much as possible – which would be possible (including via the recapitalisation of the affected banks), given the fact that the Greek debt only represents 3.7% of the eurozone's GDP[2]. In order to prevent Member States from behaving like stowaways this debt should be conditioned by the temporary relinquishment of budgetary sovereignty on the part of Greece, since its public debt issues would be subject to the agreement of its partners in the eurozone. The Greek Parliament would of course remain in control in terms of budgetary choice regarding revenues and spending, but its room of manoeuvre would be limited as far as the level of deficit to be tolerated or the implementation of reforms as inevitable as the fight to counter tax evasion, were concerned.

In all events the debt crisis is a challenge to national budgetary sovereignty. This is still the source of a great amount of reticence but budgetary sovereignty is in fact already greatly reduced due to creditor dependency. The only possible solution now seems to lie in refashioning budgetary sovereignty on a European level. However, to do this we have to accept that some decisions and resources will have to be shared and that certain common rules will have to be respected. All of the difficulty lies in deciding how to distribute the burden. But the more we delay this, the higher the price will be for Europe as a whole.

3. European Economic Government: an Inevitable Question – what real answers can we give?

Apart from the burning issue of the sovereign debt crisis in the eurozone, the issue of harmonising national budgetary policies comes to the fore. The ability to respond to economic cycles and to avoid budgetary mistakes supposes the formation of a legitimate authority that is able to take decisions to embrace the entire eurozone. We might call this authority, European economic government[3].

At the beginning of 2010 Angela Merkel caused a surprise as she adopted this idea, first used by François Mitterrand, which had until then remained a vague one. Angela Merkel intended to provide it with a meaning that was more in line with Germany's expectations: the enhancement of the rules governing budgetary discipline linked to the establishment of more automatic surveillance mechanisms. This view mainly inspired a series of regulations and directives put forward by the Commission and approved in September by the European Parliament, together with the launch of the European Semester, which allowed the Commission and the Council to issue opinions on national budget drafts. During the Franco-German Summit of August 2011, Angela Merkel and Nicolas Sarkozy added a political dimension to the debate by suggesting the formation of a council comprising eurozone Heads of State and government, who would meet twice each year, with as its leader, a stable chair, elected for two and a half years. In September 2011 Jean-Claude Trichet said he wanted to launch a "confederal government with a confederal finance minister who would be able to underwrite overall governance at the heart of the eurozone and impose decisions." To turn this idea into a reality the Presidencies of the Commission and the European Council might be undertaken by one person only, which the present treaties do not rule out[4]. Likewise the European Commissioner for Economic and Financial Affairs might chair the ECOFIN Council. With a system like this it would be easier for the EU to express itself as one in the international institutions, as it does already at the WTO via the European Trade Commissioner.

Some important steps have therefore been made. However the foundations of European economic government are weak in two ways: the non-involvement of parliaments and the fact that this government does not have its own budgetary means of intervention. To remedy the first problem national parliaments and the European Parliament might be involved more in the European Semester and in European budgetary decisions. Alain Lamassoure[5], chair of the budget committee at the European Parliament suggested the creation of an inter-parliamentary conference involving national parliament and European Parliament representatives. To remedy the second problem we might consider increasing European budgetary capabilities, which might take place in several different ways: the funding of investment projects via European loans (project bonds), the

2. For the countries which represent a higher share of the eurozone GDP (Italy or Spain), this type of solution is out of the question. This is why it is vital to have a lender of last resort which is able to dissuade speculation.

3. For a more detailed disucssion of the shape economic government might take and the obstacle to overcome, see Jean-François Jamet, L'Europe peut-elle se passer d'un gouvernement économique ?, La Documentation Française, Collection "Réflexe Europe-Débats", 2011.

4. On this point see Thierry Chopin, "Europe and the Need to Decide: is European Leadership possible?", in T. Chopin and M. Foucher (dir.), State of the Union 2011. Schuman Report on Europe, Lignes de Repères, 2011.

5. Alain Lamassoure, "From Financial to Budgetary Solidarity" in State of the Union 2011. Schuman Report on Europe,, op. cit.

creation of a European treasury and the pooling of part of Member States' debts (eurobonds) – probably with a bonus-malus scheme to reward the most virtuous States in terms of their budgetary policy[6] –, an increase in the European budget or an increase in the EIB's lending capacities. However it will be in this area that progress will technically and politically be the most difficult to achieve.

CONCLUSION

As the European economy dances on the edge of the abyss, economic policy is becoming increasingly federal in nature. However this has revealed a problem in that the latter is not based on any prior model and that it does not have the required political legitimacy. If we want European policies to make sense again we have to provide them with vital substance and have the courage to debate their content in public so that real European economic governance can emerge.

Author : Jean-François Jamet
is an economist . He lectures at Sciences Po on the political economy of the European Union
http://www.jf-jamet.eu/

6. See Patrick Artus, Thibaut Cuillière and Badr El Moutawakil, "Quel système de bonus/malus sur l'Eurobond?", Flash Economie, Natixis, 22 August 2011, n°613.