Oesterreichische Nationalbank

Eurosystem

Workshops

Proceedings of OeNB Workshops

A Constitutional Treaty for an Enlarged Europe: Institutional and Economic Implications for Economic and Monetary Union

November 5, 2004

No. 4

The issues of the "Workshops – Proceedings of OeNB Workshops" comprise papers presented at the OeNB workshops at which national and international experts, including economists, researchers, politicians and journalists, discuss monetary and economic policy issues.

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Imprint:
Publisher and editor:
Oesterreichische Nationalbank
Otto-Wagner-Platz 3, AT 1090 Vienna
Günther Thonabauer, Secretariat of the Governing Board and Public Relations
Internet: www.oenb.at
Printed by: Oesterreichische Nationalbank, AT 1090 Vienna
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DVR 0031577

Vienna, 2005

Contents

Editorial 5
Isabella Lindner, Paul Schmidt

A Constitutional Treaty for an Enlarged Europe: Institutional and Economic Implications for Economic and Monetary Union 9
Josef Christl

The European Constitution and Economic and Monetary Union 12
René Smits

A Constitutional Treaty for an Enlarged Union: Are there Fundamental Changes for EMU? 20
Isabella Lindner, Marlies Stubits

Commentary 48
Fritz Breuss

Financial Stability Arrangements in Europe: A Review 50
Anne-Marie Gulde, Holger C. Wolf

Commentary 68
Karin Hrdlicka

Fiscal Policy and Democracy in Europe 76
Stefan Collignon

Commentary 97
José Marin

List of "Workshops – Proceedings of OeNB Workshops" 100

Periodical Publications of the Oesterreichische Nationalbank 101

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The presented articles were prepared for an OeNB workshop and therefore a revised version may be published in other journals.

Editorial

The ESCB/Eurosystem and the OeNB closely followed the debates on Economic and Monetary Union (EMU) issues within the Convention on the Future of Europe and the negotiations during theIntergovernmental Conference and contributed to them at various stages.[1] The ESCB/Eurosystem is part of the Community framework and has an institutional interest in developments within the EU. Essentially, all legal and institutional changes made in EMU determine the framework conditions under which the ESCB/Eurosystem operates.

As the Treaty establishing a Constitution for Europe (Constitutional Treaty) was signed by the Heads of State or Government of the Member States of the European Union on October 29, 2004[2], the Oesterreichische Nationalbank (OeNB) organized an international workshop titled *A Constitutional Treaty for an Enlarged Europe: Institutional and Economic Implications for Economic and Monetary Union.* The workshop, which took place on November 5, 2004 at the premises of the OeNB in Vienna, gave an overview of the institutional implications the Constitutional Treaty may have for EMU and analyzed the institutional framework for financial stability in Europe and the role fiscal policy and the Stability and Growth Pact play in an enlarged Europe. This volume puts together the papers and comments presented at the workshop.

In his opening remarks, *Josef Christl*, OeNB, stressed how important the Constitutional Treaty, which aims at rendering the enlarged EU more effective, transparent and democratic, was for European integration. According to Christl, the process of ratifying the Constitutional Treaty will be a great challenge but, at the same time, presents an opportunity to put the debate about the future of the European Union into a broader perspective and to bring the European integration project closer to the people.

Now that the EU has been successfully enlarged, the new constitutional architecture should be used to deepen the European integration process. The euro as the single currency plays a key role in this respect, serving as a catalyst for political integration and continuous economic reforms. It represents a successful step toward integration and stands for both unity and variety within Europe.

[1] Article 48 of the Treaty on European Union stipluates that the ECB, and thus the national central banks, are to be consulted on any institutional changes in the monetary area.

[2] The Constitutional Treaty will be submitted to the Member States for ratification and shall enter into force on November 1, 2006.

René Smits, of the University of Amsterdam, held the keynote speech at the workshop, in which he outlined the structure of the Constitutional Treaty. The Constitutional Treaty contains only minor changes to the institutional framework of EMU; first and foremost, it reconfirms the ECB's independence and, at the same time, provides for its formal integration into the institutional framework of the EU. Furthermore, the Constitutional Treaty states that members of the Executive Board of the ECB have to be appointed by a qualified majority and that the Council of Ministers has to take decisions based on a double majority system. It also formally uses the terms Eurosystem and Eurogroup, introduces the function of a president of the Eurogroup, puts forward that euro area Member States are to have more competences, and contains a declaration by the Heads of State or government on the Stability and Growth Pact.

The so-called *exit clause* only partially defines the course of action for Member States wishing to leave the European Union and fails to provide a withdrawal procedure. The Constitutional Treaty takes an intergovernmental approach, introducing an EU foreign minister, electing a European Council president and principally holding on to the rotating EU presidency. By extending the scope of the codecision procedure, it renders the European Parliament more influential. The European Commission's role as a motor of integration is only slightly expanded.

In conclusion, the Constitutional Treaty simplifies all treaties established so far; nevertheless, compared with the U.S. Constitution, it is still complex. The stipulated amendment procedures do not exactly facilitate the evolution process of the Constitutional Treaty. One has to accept that creating a constitution is a continuous and dynamic process. Smits considers the current document a successful step toward integration but calls for further steps to follow.

Isabella Lindner and *Marlies Stubits*, OeNB, presented a study in which they examined how multilevel economic governance in the European Union is affected by the Constitutional Treaty and which implications these effects have for EMU in terms of effectiveness and efficiency. They argue that the Constitutional Treaty may improve the EU-25's ability to act on both the European and the international level by providing for stronger personalization of the EU's institutions and the Eurogroup and by reducing the size of the European Commission.

Furthermore, the Constitutional Treaty lays down several new provisions and voting rights pertaining exclusively to the euro area Member States. It also formalizes the Eurosystem, de facto integrates the Eurogroup and introduces a longer-term president of the Eurogroup, thus changing the current system of multilevel economic governance in the EU. As heterogeneity among Member States has increased with enlargement, the euro area is more and more turning into a *center of gravity* for integration.

Whether or not, the Constitutional Treaty will render the decision-making process more efficient will only be revealed when the treaty comes into effect. At

any rate, introducing a double majority system signifies a radical departure from the previous voting system.

The Constitutional Treaty does not contain any substantial changes with regard to monetary union, as most of the changes are of technical nature only. It reaffirms the framework conditions for monetary union as embodied in the Treaty on European Union.

Fritz Breuss, Vienna University of Economics and Business Administration, stressed the intergovernmental character of the Constitutional Treaty. He warned that extending the powers of the Eurogroup and introducing a president of the Eurogroup could be a source of conflict among the Ecofin Council, the Eurogroup and the ECB. Economic policy coordination, whose core element is the Economic and Financial Committee, remains complex and cumbersome. It rests to be seen whether this type of coordination ultimately has more advantages or disadvantages. He declared the European Commission the big loser in the bargaining game for the distribution of powers among the European institutions.

Holger Wolf, Georgetown University, spoke about the challenges arising from financial integration concerning the institutional setup of financial market supervision. In view of the increasing number of cross-border an cross-sector financial institutions, Wolf advocated a two-tier system consisting of an EU authority responsible for supervising large European financial institutions and national authorities supervising only institutions that primarily operate in the domestic markets. When and how such a structure should best be implemented is a much more difficult issue. Since the number of institutions operating EU-wide remains low, and as Basel II brings about a range of substantial changes, a gradual transfer of supervisory powers to the current coordinating bodies (evolutionary approach) would be desirable.

When it comes to crisis prevention and the allocation of costs for lender-of-last-resort (LOLR) operations, however, a formal framework should be established as quickly as possible. Scenarios in which large international banks with their headquarters in a small EU Member State experience problems which exceed the national central bank's capacities are by all means realistic.

Karin Hrdlicka, OeNB, pointed out that the moment for changing the supervisory architecture has not yet come. The level 3 Lamfalussy committees have been established only recently, mainly to address challenges arising from the integration process by implementing EU legislation more consistently and by converging supervisory practices. In terms of stability, a European supervisory authority seems to be a realistic solution, but only in the long run and only if organized on a decentralized basis.

Stefan Collignon, London School of Economics, advocated establishing coherent fiscal policies at the EU level to optimize the European monetary and fiscal policy mix. There are more advantages than disadvantages to centralizing

public finances (welfare and stability gains) while allocating budgets on a decentralized basis (efficiency gains).

The EU budget must have democratic legitimacy, and costs must be allocated more evenly. Net contributors are more prone to undergo excessive deficit procedures in times of economic downturns than net recipients, as, according to the rules for excessive deficits, net transfers from – as opposed to net payments to – the EU are not taken into account. Having its own source of funding (EU tax) would equip the EU better for its negotiations on the financial perspective; interregional transfers could be conducted via *tradable deficit permits*. Elections to the European Parliament would thus determine decisions on how to use European taxpayers' money. They would ensure that the EU budget reflects the preferences of the majority of citizens and overcomes individual interests. Discussing and voting on the budget in the European Parliament, with proposals from the Commission and the consensus of the Council (depending on the legislative procedure), would foster European democracy and identity.

José Marin, ECB, pointed out that there were different definitions of federalism in Europe. The current expenditure structure of the EU budget is by all means justified and corresponds to the fragile institutional balance within the EU, as well as to the current level of European integration. For most EU Member States, the implementation of a more fiscal policy-oriented federalism would currently not be acceptable.

Isabella Lindner
Paul Schmidt

A Constitutional Treaty for an Enlarged Europe: Institutional and Economic Implications for Economic and Monetary Union
Opening Address

Josef Christl

Director
OeNB

Ladies and Gentlemen,

it is a great pleasure to welcome you here at the premises of the Oesterreichische Nationalbank in Vienna. The topic of our workshop, *A Constitutional Treaty for an Enlarged Europe: Institutional and Economic Implications for Economic and Monetary Union*, and its timing are well-chosen. We are proud that our event, just like the last years seminar on the European Convention, attracts again a distinguished international but also national audience and high-level speakers and discussants. Your positive response indicates that there is need and demand for our activities. I think it is very important to intensify the dialogue on the institutional issues of European integration and EMU.

It is needless to say that we are experiencing exciting times. The last round of enlargement of the European Union was completed almost exactly half a year ago. Only last week the Heads of State and Government of the European Union signed the EU-Constitutional Treaty, which marks, of course, a further milestone in the process of European integration. It is the Constitutional Treaty that provides the steps needed to make an enlarged Europe work in a better way. Its objective is to render the Union more effective, transparent and democratic. After its ratification, the Constitutional Treaty will consolidate and simplify the existing treaties. The process of ratification in itself will be a major challenge but also an opportunity to bring Europe closer to its citizens. An opportunity, which should not be missed. A multilevel debate will be started about what kind of Europe people really want. And the necessary dialogue that, in the end, can help bridging the gap, which, in

my opinion, exists at the moment between the political elite in Europe and the people in the different Member States.

The new constitutional architecture offers a unique opportunity to further deepen the integration process. In this context of constant development and challenge we have to provide stability in a broad sense: political stability, macroeconomic stability, financial market stability and, of course, price stability. The current framework is a good basis and provides for such a broad concept of stability.

Ladies and Gentlemen,

it is the euro that today provides a stable anchor in not so stable times. The single currency has triggered considerable fiscal and structural reform in Europe, but a lot remains to be done.

The common currency also holds out the promise of fostering European integration in areas far beyond Monetary Union. Indeed, in many respects, the euro has proven to be a driving force and catalyst for Europe's political integration and economic reforms. I consider the euro as an important token of identity for a modern, dynamic and open Europe. More than any complicated legal act our common currency tells the simple story of successful integration. The euro communicates the European idea.

But EMU requires strong political fundamentals in the sense of a closer political union. Therefore, it is essential for economic governance that significant progress is made in the general political governance of the Union. With the Constitutional Treaty the Union wants to take an important step forward.

Ladies and Gentlemen,

the ECB and the national central banks closely followed the debates within the Convention and the negotiations during the Intergovernmental Conference. Together, we contributed to them at various stages. This was motivated by the fact that the ECB and the ESCB are part of the Community framework and we therefore have a natural interest in institutional developments within the EU and, of course, within EMU. Let us not forget that these developments, at the end of the day, determine the framework conditions under which we operate. The Treaty of the European Union requires that the ECB, and thus the national central banks, are to be consulted on any institutional changes in the monetary area. It was and it will be essential for us, to monitor the integration process at all stages and express our opinion whenever appropriate and necessary.

Let me now come to the program of today's workshop which aims at discussing the possible institutional and economic implications of the Constitutional Treaty for EMU.

We will start with a first-hand assessment of our key-note speaker Professor Smits, who is Jean Monnet Professor of the Law of EMU at the University of Amsterdam. He will give us an overview of the constitutional process and will emphasize the economic and monetary issues, which where at the core of discussion in the Convention and the Intergovernmental Conference.

The key-note speech will then be followed by three sessions:

In the morning-session Ms. Lindner and Ms. Stubits of the Oesterreichische Nationalbank will evaluate whether the Constitutional Treaty actually introduces new elements and fundamental changes for EMU. Their presentation will analyse possible developments in the area of efficiency, effectiveness and institutional balance of economic governance.

Another matter of interest is, of course, the external representation of the euro. EMU has clearly strengthened Europe's international position. In this respect it will also be interesting to discuss the role of the newly created President of the Eurogroup.

This first presentation will be discussed by Professor Breuss, who is Jean Monnet Professor of European Economic Integration of the University of Economics and Business Administration in Vienna.

After lunch, in session 2, Professor Wolf of Georgetown University will present his views on the development of the new institutional setting for financial stability in Europe. This presentation touches upon a topic that is crucial in our efforts to deepen the European Integration process. The speaker will look on whether the supervisory structures are adequate to accompany a stable financial market integration in Europe.

This presentation will be discussed by Ms. Hrdlicka of the Oesterreichische Nationalbank.

And finally in section III Professor Collignon of the London School of Economics, will talk about fiscal policy and the Stability and Growth Pact in the enlarged European Union. There is an intensive discussion going on where the different standpoints of Central Banks and the Ministries of Finance are brought to the surface. For us central bankers, the Stability and Growth Pact is a corner stone of EMU and absolutely crucial for its smooth functioning.

The viewpoints of Professor Collignon will be evaluated by José Marin, head of Fiscal Policies Division at the ECB.

In concluding – again a warm welcome to all of you and I would like to thank in advance all speakers and discussants for their work and their important contributions.

Ladies and Gentlemen,

I wish you a fruitful, stimulating and successful workshop.

The European Constitution and Economic and Monetary Union

René Smits

Jean Monnet Professor of the Law of the EMU
Universiteit van Amsterdam

In my presentation, I will introduce the main elements of the European Constitution (Constitution). I will start with a few institutional issues and will then cover the EMU-provisions of the Constitution with a special emphasis on the three main elements of EMU: capital and payments, economic union and monetary union. Afterwards, I will turn to other EMU aspects of the Constitution. I will round up my presentation with concluding remarks.

First, let me give you my opinion on how the Constitution impacts the relations between the Union and the Member States. In the very first part of the Constitution Article I-5, numbered "I" for the part of the Constitution and "5" for the number of the provision, stresses that the Union is to respect the equality of Member States, the national identities and their essential state functions. The national identities are inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-government. The essential state functions are considered to include territorial integrity, maintaining law and order and safeguarding national security. For a Constitution, which is bound to bring us one step further in the European integration process, this is indeed strange language. In Article 4 of the current EU Treaty we find that the Treaty respects national identities of Member States. Article I-10 stresses the requirement of loyal corporation between the Union and the Member States. A new element in a text of primary law, such as the Constitution, is Article I-6, which states the primacy of Union law over the law of the Member States. Article I-11, which in its essence embodies the same approach as the current EU treaties, states that powers can only be exercised by the Union when they have been attributed to it. The wording used, in particular the principles of conferral, subsidiarity and proportionality, gives the impression that Member States are conferring competences to the Union, which they can always take back. Interestingly, non-conferred powers remain with the Member States.

In the area of EMU the coordination of economic policies is not listed as a so-called shared competence. Nevertheless, I consider the coordination of economic policies to be a shared competence. Care is taken to avoid anything that could be

explained as conferring on the Union itself a competence to coordinate the economic and employment policies of the Member States.

Let me briefly outline one important aspect of the voting system in the Council of Ministers as from the 1 November 2009, supposing the Constitution will be ratified by all Member States. When there is a proposal of the Commission or of the Union Minister of Foreign Affairs a qualified majority shall be defined as at least 55% of Council members comprising at least 15 of them and representing 65% of the population of the Union. A blocking minority must include at least 4 Council members. If the Council is not acting on a proposal by the Commission or the Union Minister for Foreign Affairs, qualified majority shall be defined as at least 72% of Council Members representing Member States comprising at least 65% of the population of the Union. This system is all for the future because, as the Constitution makes clear in Protocol No. 34, the double majority system will not take effect before 1 November 2009. As of 1 November 2004, a qualified majority vote, on the basis of a proposal from the Commission, requires at least 232 out of 321 votes representing a majority of the Member States. In cases where the decision is not based on a proposal by the Commission, the 232 votes must represent two thirds of the Member States, which in the EU of 25 would be 17. A member of either the European Council or the Council may request that it is established that the Member States comprising the qualified majority represent at least 62% of the population of the Union. As said, the improvement of the qualified majority voting system introduced will take effect only at a later stage.

Let me highlight a few aspects regarding the European Council which now finds itself in the constitutional part of this new text. We all know that the European Council consists of the Heads of State or Government of the Member States, together with its President and the President of the Commission. The Union Minister for Foreign Affairs shall also take part in its work. The European Council's task is to provide the Union with the necessary impetus for its development and to define general political directions and priorities. The European Council shall not exercise legislative functions. This raises the question whether the legislative function, which I would have attributed to the European Council in the past, could be performed in the future. I am, of course, referring to the ERM-II resolution and the resolution on the Stability and Growth Pact. Article IV-38, third paragraph states that resolutions or positions by the European Council shall be preserved until they have been deleted or amended. Still, I would argue that under the Constitution there will be no more legal basis for the European Council to interfere in the sphere of EMU as there is under the current treaties.

The Commission continues as an institution where every Member State has its own Commissioner. Only after the inauguration of the first Commission under the new Constitution will we see a smaller-sized college, corresponding to 2/3 of the number of Member States. From my point of view it would have been important to elect the President of the Commission by the European Parliament on a proposal by

the European Council taken by qualified majority. Furthermore, the rules concerning the Commission do not provide for the assent for, or responsibility of, individual members of the college. The Constitution does not grant the European Parliament the right to reject individual members of the Commission.

But the role of the European Parliament has clearly been strengthened. Under the Constitution, co-decision is the ordinary legislative procedure. Furthermore, the European Parliament jointly exercises legislative and budgetary functions and also plays a crucial role in the political control and consultation process and in the election of the President of the Commission

In the area of EMU the ordinary legislative procedure may be introduced by a decision of the European Council; it can be blocked by any national parliament. The Constitution also stipulates that where Part III provides that the Council should act by unanimity, the European Council may adopt a European decision authorizing the Council to act by qualified majority. It is important to remember that the replacement of the excessive deficit protocol, one of the key-elements of the Stability and Growth Pact, requires the adoption of a European law. Such an amendment of the excessive deficit protocol could be subject to the ordinary legislative procedure. Moreover, a possible amendment to the provisions of the Statute of the European System of Central Banks (ESCB) could also be based on the normal legislative procedure. There are also areas of EMU which are subject to decision-making by the Council but do not lead to legislative acts, such as the adoption of positions in the field of external representation.

In the field of capital and payments the basic principle that restrictions both on the movement of capital and on payments between Member States and between Member States and third countries shall be prohibited, remains unchanged. Article III-158 newly states that, on a request from a Member State and in the event that the Commission does not act within three months, the Council may decide that restrictive tax measures vis-à-vis third countries are justified and compatible with the internal market. The current exceptions for tax purposes and prevention of law infringement as well as for statistical or administrative declarations of capital movements have been maintained which, in the context of EMU, I find rather peculiar. Within a single monetary area the provision to require administrative declarations of capital movements should not be necessary. The safeguard measures, which can now be adopted under Article 59 of the current treaty to ring-fence the Community in case of threat or serious difficulties for EMU, have been maintained and are still operative for the entire EU. Here, the distinction between the EU and the euro area has not been followed. The two-tiered decision-making regarding the interruption of economic and financial relations with third countries is also maintained. The Council acts on a joint proposal from the Union Minister of Foreign Affairs and the Commission and informs the European Parliament.

Let me now turn to the provisions regarding economic policy. From a general point of view, the picture seems rather unchanged. There are a few extra

competences for the Commission, some voting changes in the Council, the recognition of the Eurogroup, the introduction of a chairperson of the Eurogroup and a declaration on the Stability and Growth Pact. I would consider the EMU chapter in the Constitution a missed chance. The symmetry of the ways economic and monetary policy objectives are to be pursued under the Constitution presents a major challenge for the future work of EMU. It was not at all surprising that the British government expressed its satisfaction with the status quo and the lack of changes in economic governance. The Member States remain clearly in charge of economic policy coordination. A provision giving the Commission power to propose economic policies for Member States with an excessive deficit has been dropped.

With regards to the Broad Economic Policy Guidelines and multilateral surveillance, the position of the Commission has been slightly strengthened. In the future, it will not be the Council but the Commission that addresses a first warning to Member States in case of deviation from the guidelines. On the other hand, the recommendation the Council addresses to the Member State concerned is still based on a recommendation, and not a proposal, by the Commission. The Council, on a proposal from the Commission, may decide to make its recommendations public. In order to increase transparency, I think the recommendations should be made public immediately.

What is new is that the Member State concerned does not vote on any recommendation addressed to it. And special parts of the Broad Economic Policy Guidelines concerning the euro area can be adopted without the votes of the so called "outs".

Let me now move from the so-called soft law to the hard law of the excessive deficit procedure. The Council will establish the existence of an excessive deficit on a Commission proposal instead of a recommendation. Under the Constitution the Member State concerned may present his case but will loose its right to vote. Another new element is that the Commission, and not the Council, can address an opinion to the Member State concerned. On the basis of a recommendation by the Commission, the Council adopts its recommendations, which are addressed to the Member State concerned "without undue delay". In the light of past experience with the Stability and Growth Pact this new wording is indeed interesting. Again the recommendation will not be published unless expressly so provided. The individual steps of the excessive deficit procedure concerning the publication, the notice and the possible sanctions of a euro area Member State can be taken by Members of the currency union without the vote of the "outs".

The Eurogroup is recognised in a special Protocol but has no formal decision-making powers. The President of the Eurogroup will be elected for 2½ years by a majority of euro area members.

The declaration on the Stability and Growth Pact states that raising growth potential and securing sound budgetary positions are the two pillars of the

economic and fiscal policy of the Union and the Member States. It confirms the commitment to the Stability and Growth Pact as the framework for coordinating budgetary policies and reaffirms the Lisbon Strategy. It also says that Member States should use periods of economic recovery actively to consolidate public finances and improve their budgetary positions. Finally, it welcomes any strengthening and clarifying implementation of the Stability and Growth Pact.

I will now turn to the provisions concerning the monetary union. In the current legal texts, the ECB is already a body of the Community. As stated by the European Court of Justice in the European Anti-Fraud Office (OLAF) case, "the ESCB falls squarely within the Community framework". Furthermore, the Court stresses that the recognition of the ECB's independence "does not have the consequence of separating it entirely from the (EC) and exempting it from every rule of Community law". In the Constitution the ECB and the NCBs are grouped together in Article I-30 which can be found under Title IV "The Union´s institutions and bodies" in Chapter II "The other Union Institutions and advisory bodies". Article I-30 explains, just as the current Treaty, that the ESCB is composed of the ECB and NCBs. It also introduces the Eurosystem, which, of course, consists of the ECB and the euro area NCBs. While the Constitution refers to the Eurosystem as the competent body to conduct the monetary policy of the Union, the Statute of the ESCB refers to the ESCB. Although in the case of the conduct of monetary policy, the expression "ESCB" refers to the ECB plus the central banks of the Member States whose currency is the euro, the wording can be quite misleading. The Constitution states that the ECB is an institution and has legal personality. It shall be independent in the exercise of its powers and in the management of its finances. This independence shall be respected by the Union institutions, bodies, offices and agencies and the governments of the Member States. Furthermore, Article I-30 explains that the ESCB is governed by the ECB´s decision-making bodies, its primary objective is price stability and its secondary objective is to support the general economic policies in the Union. Although the legal nature of the ESCB and the Eurosystem are not further qualified in the Constitution, I would regard them as bodies of the EU as well. Article III-382 provides that the Executive Board members will, in the future, be appointed by qualified majority of the members of the European Council on a recommendation of the Council and after consulting the European Parliament and the Governing Council of the ECB. In the European Council neither its full-time President nor the member of the Commission present will have the right to vote. It is interesting to note that while the President of the Ecofin Council and the responsible Commissioner have a standing invitation to the ECB Council meetings and the ECB President is invited to Ecofin Council meetings and participates actively in the monetary dialogue with the European Parliament the ECB does not participate in the Commission meetings when EMU matters are on the agenda.

In the context of regulatory powers I would like to mention that the Constitution distinguishes between legislative and non-legislative acts. European laws, former EC regulations, and European framework laws, former EC directives, may be adopted on a recommendation of the ECB if so specifically provided. The ECB will still be able to adopt its own legal acts, European regulations and decisions, but they will be so-called non-legislative acts.

It is clear that the single monetary policy is an exclusive Union competence, at least in respect of the euro Member States. I believe that the term "monetary policy" is to be defined in the broad sense of Part III, Title III Chapter II Section 2 rather than in the restricted wording of Article III-185 (2). The Constitution should not use the same term for two different concepts. More than just the definition and conduct of the Union's monetary policy the concept should include the conduct of foreign-exchange operations, the holding and management of official foreign reserves and the promotion of the smooth operation of payment systems. I also consider the oversight of payment systems to be part of the exclusive competences of the Union, at least for the euro area Member States.

The objective of sustainable and non-inflationary growth of Article 2 of the EC Treaty has been replaced by "sustainable development of Europe based on balanced economic growth and price stability" in Article I-3 (3). EMU as a means to achieve the objectives of the Communities is no longer in the task-setting provisions but in Article III-177. Nor the guiding principles of: stable prices, sound public finances and monetary conditions and a stable balance of payments neither the principle of an open market economy with free competition, favouring the efficient allocation of resources, have changed. One of the key competences is described in Article III-191, which states that the measures necessary for the use of the euro can be laid down by European laws or framework laws.

I would like to turn now to the topic of external representation of the Union. To a large degree Article 111 of the current Treaty can now be found in article III-326. Paragraph (4) of Article 111 is reframed and integrated into the new Article III-196, which refers to the euro's place in the international monetary system. The Council, on a proposal from the Commission, shall adopt common positions and measures to ensure unified representation within the international financial institutions and conferences. Decisions are taken by the qualified majority of the Member States whose currency is the euro. From my point of view, current Community law already binds the Council to adopt such measures with regard to exchange-rate matters and even when economic policy coordination is concerned.

Article I-26 says that the Commission is to represent the EU externally except in the area of Common Foreign and Security Policy (CSFP) "and (in) other cases provided for". This wording ("other cases") could also include EMU matters. The Union will also have a new Union Minister of Foreign Affairs, who is to conduct the Common Foreign and Security Policy and who presides over the Foreign Affairs Council whereas he "ensures consistency of the Union's external action".

Apart from the Foreign Affairs Council, Member States consult each other in the European Council "before undertaking any action on the international scene or any commitment which could affect the Union's interests". I would call all of this a hexagonal external representation of the Union, which consists of the President of the European Council, the President of the Commission, the Union Minister of Foreign Affairs, the President of the Council and, in the euro area, the President of the Eurogroup and the ECB President. In line with a proposal that was discussed in the Convention but was not adopted, I think the President of the Commission should have been simultaneously appointed as President of the European Council. Hence, his or her influence on the external representation of the Union could have been increased.

The review clauses of the Constitution do not seem fully appropriate. The *ordinary revision procedure* of the Constitution includes the Convention method and a deviation from it would require the consent of the European Parliament. The *simplified revision procedure* provides for movement from unanimity to qualified majority voting and from the special legislative procedures to the ordinary legislative procedure for areas covered by Part III on the basis of a unanimous decision of the European Council with the consent of the European Parliament. The *simplified revision procedure concerning internal Union policies and action* requires a unanimous decision by the European Council.

I think that the Constitution should not be subject to such strict amendments requirements. Nevertheless, I do add that, especially, with regards to the revision of internal Union policies the need of approval by all Member States can be seen as a shield for the competences in the area of monetary union.

I would also like to draw your attention to the exit clause of the Constitution. I think this clause, which is supposed to regulate the voluntary withdrawal of a Member State, is not only badly construed but I also consider it dangerous for the euro. Let me briefly explain what the clause says. A Member State wishing to exit would notify the European Council and negotiate with the Council its exit agreement. On the part of the Union this agreement would be concluded by the Council with qualified majority and have the consent of the European Parliament before becoming law. Yet the Constitution would cease to apply to an exiting Member State from the entry into force of the withdrawal agreement or two years after its notification unless the European Council, in agreement with the exiting State, unanimously extends this period. No details are given on how to exit from the monetary union. Frankly, I think that this clause is going to reinforce the utterance of exit threats from among eurosceptics.

I would like to conclude by saying that, in my opinion, the Constitution, especially in the area of the EMU, is too intergovernmental and, in some respects, represents a small retrograde step. The Constitution is a state-centered text that does not sufficiently strengthen the Commission. In EMU, the Council maintains its predominant position and the European Parliament still needs to develop its

channels of influence. Let me also remind you of the dual/triple and even six-fold external representation of the Union. I think we have not been able to figure out how we want to present ourselves on the international scene. Moreover, the Constitution is a very long and not really comprehensive document.

The text stipulates too many competences and too little power. Since Maastricht we have experienced a gradual extension of competences in areas such as energy, space or civil protection instead of focusing on the core elements of a federal government such as the internal market, EMU, external policy and freedom, security and justice. We are facing a wide variety of challenges and important decisions lie ahead of us. The threat of terrorism and the decision on Turkey's membership of the Union are cases in point. But these challenges might also be an opportunity to deepen our integration efforts. We should accept that this Constitution is not going to win a beauty price, but let us not forget that we are in a continuous constitutional process. We can be assured that this Constitution will not last for 50 years.

The constitutional discussion is a first step to ensure that the distance between the EU citizens and their Union can be bridged. I will vote in favour of this text; not only because it is in the interests of ourselves, but also in the interest of our children and grandchildren. Allow me to conclude by quoting from the introduction of a book I am reading (Jeremy Rifkin's, The European Dream – How Europe's Vision of the Future is Quietly Eclipsing the American Dream):

"The fledgling European Dream represents humanity's best aspirations for a better tomorrow. A new generation of Europeans carries the world's hopes with it. This places a very special responsibility on the European people, the kind our own founding fathers and mothers must have felt more than two hundred years ago, when the rest of the world looked to America as a beacon of hope. I hope our trust is not trifled away."

A Constitutional Treaty for an Enlarged Union: Are there Fundamental Changes for EMU?

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1. Introduction[1]

On June 18, 2004, at the European Council meeting in Brussels the Intergovernmental Conference (IGC) reached an agreement on the Treaty establishing a Constitution for Europe[2]. After the formal signature of the Constitutional Treaty (CT) by the Heads of State and Government in Rome on October 29, 2004, the final draft was submitted to the Member States for ratification, and shall – from the present point of view – enter into force at the earliest on November 1, 2006.

Even the way the CT was brought about – by calling a Convention to prepare a draft European constitution – meant a major departure from usual change processes in the EU. And, although, the final text is a compromise of compromises, for many observers the CT is a milestone in the European integration process. The Convention's draft text and the present CT reflect the unresolved and long-term issues of the nature and purpose of the EU as well as the conflict between the supranational and intergovernmental approach. In addition, many agreed that the Treaty of Nice, which had formally ensured that an EU- 27 would be able to function, had to undergo further adjustments in order to work well for an enlarged

[1] Helpful comments by Helene Schuberth (OeNB) and Christian Just (OeNB) are gratefully acknowledged.

[2] In the following, the Treaty establishing a Constitution for Europe will be referred to as Constitutional Treaty.

EU. The CT incorporates important amendments that in some areas will bring about more efficiency and also democratic legitimacy and will help to deliver public goods more effectively on a European level. With referenda pending in several Member States, the CT might never be ratified in its present form, but still merits a more in depth analysis, as ratification in an adjusted form could very well happen.

In this paper we, therefore, explore the further evolution of European economic and monetary integration under the framework of the CT, taking into consideration the likely effects on an enlarged EMU. The starting points for our evaluation are on how institutional balance, i.e. multilevel economic governance, effectiveness of implementation of economic policy measures and efficiency – primarily of decision-making – are affected by the CT.

The EU has no *division of powers* in the classical sense, but a *system of institutional balance* (Alesina et al., 2004) or *multilevel governance*[3] (Aalberts, 2004, Swenden, 2004, Breuss et al., 2004), relying on a division of functions and based on overlapping authorities and competing competences among different levels of governments and the interaction of actors across those levels. This leads to conflicts and very often to confusion among institutions, notably the Council and the Commission and the Member States. We will look at the question in which direction the CT has moved multilateral governance of EMU and whether the CT has contributed to more transparency and legitimacy in EMU's institutional set up.

This issue is also linked to the question of effectiveness of implementation of economic policy measures. Instruments of EU economic policy range from a single monetary policy, coordination of joint economic policy measures, multilateral surveillance, ex post evaluation and recommendations, quantitative, but non-binding targets, peer pressure, best practice, open dialogue among policy makers to common positions in external representation. Successful implementation and impact of these measures depends also on the way multilevel governance works. As the sovereign power of EU institutions is limited, enforceability depends in most cases on Member States. Targets are very often not seen as a binding constraint by Member States. Which of the newly introduced provisions of the CT could enhance effectiveness in EMU?

For lack of other measurements we will try to evaluate efficiency of decision-making according to voting rules, the extension of qualified majority voting (QMV), thresholds for QMV compared to Nice and working methods of the Council. Many critics argue, not unjustified, that using voting rules as a measurement of efficiency is not entirely legitimate as votes are taken only for

[3] The term multilevel governance is used to describe emerging structures and processes of policy-making in the EU, straddling the notions of intergovernmentalism and supranationalism on the one side as well as the traditional distinctions between domestic and international politics (Aalberts, 2004).

about 10% of decisions in the Council. However in an enlarged EU it may be expected that votes will be taken more often. Is the decision making system under the CT efficient enough for an enlarged Union? With the introduction of new functions, for example a longer term President of the Eurogroup, the CT has clearly set out on a path of *personalisation*. Does this bring about more leadership and continuity in multilevel economic governance and therefore more efficiency in EMU ?

The paper is organized as follows: in section 1 we describe the CT's architecture and how some of its aspects could affect EMU; in section 2 the new decision-making procedures and institutional working methods are analyzed and how they would drive efficiency in EMU; in section 3 we try to illustrate the nature of institutional balance and multilevel governance, efficiency and effectiveness with some policy examples, i.e. monetary policy, coordination of economic policies and external representation of the euro area.

2. The Architecture of the Constitutional Treaty and EMU

The CT establishes a consistent constitutional architecture taking the place of the three-pillar structure of the set of existing Treaties. A coherent legal framework with four main parts is introduced:

- Part I *Constitutional Provisions*,
- Part II *The Charter of Fundamental Rights of the Union*,
- Part III *The Policies and Functioning of the Union*,
- Part IV General and Final Provisions.

Part I, Part III, Part IV and the protocols on the ESCB/ECB Statutes, on the excessive deficit procedure (EDP), on the Eurogroup and on the Convergence Criteria as well as the Declaration on the Stability and Growth Pact (SGP)[4] contain the specific legal and institutional underpinnings for EMU.

In this context, the question emerged whether the *constitutional provisions* of Part I are supreme over Part II, Part III and Part IV. So far, the European Court of Justice has considered all parts of the Treaty on European Union equal. However, the provisions in Part I of the CT, which, inter alia, specify the institutional framework, prevail over the provisions of the other parts in so far as their amendment requires convening an IGC. By contrast, *Internal Policies and Action* (Part III, Title III) and thus also the provisions on EMU are subject to a simplified revision procedure under which it is not necessary to call a Convention or an IGC. This may introduce an element of flexibility into the further development of EMU

[4] This Declaration is part of the Treaty, see CIG 87/04 ADD 2, III/A/ No. 17, Declaration on Art. III-184.

governance. Some critics consider that this innovation falls largely short of what is required for ensuring some flexibility in the CT, but consider it to be a small step in the right direction (Grevi, 2004).

The economic objectives of the Treaty on European Union (TEU) are in principle reaffirmed. The CT defines also those relevant to EMU: "…sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress,…". The inclusion of price stability as an objective of the Union was heavily contested and only added to the text at a very late stage of IGC negotiations, to some degree due to the lobbying power of the ESCB. The application of the simplified revision procedure for Part III made it even more important that price stability had been integrated in the objectives laid down in Part I of the CT. This implies that price stability is not only an operational objective of the ESCB/Eurosystem but an objective that is binding for both the Union and its Member States. As a consequence, changes in fundamental values such as price stability are less likely to occur, because they are subject to the ordinary revision procedure.

The CT also brings about some achievements with regard to more democracy and legitimacy. Co-decision as the standard legislative procedure will further enhance the position of the European Parliament (EP) and thus strengthen not only the representation of citizens on a Union level, but also the position of the EP itself in general economic governance. The Union will have a single legal personality and can thus act and be held accountable on the international scene. Legal instruments and procedures are simplified. The definition of Union competences and the clarification of the relation between the Union and the Member States, aiming at defining multilevel governance, mark some progress towards more transparent decision-making and division of tasks.

The Union competences are governed by the principle of deferral, i.e. the Union shall act within the competences conferred upon it by the Member States in the CT, of subsidiarity and of proportionality. The CT strengthens the procedures by which the principles of subsidiarity and proportionality are controlled. It will be possible for Member States to address the European Court of Justice in cases where subsidiarity might not have been observed. Additionally, there is an early-warning-mechanism concerning legal acts contradicting subsidiarity. The CT provides clarification by defining six areas of exclusive competence for the Union, areas of shared competences, coordination of economic and employment policies, special provisions for common foreign and security policy and areas of supporting, coordinating and complementary action.

The debate about subsidiarity has not produced a catalogue on which issues should be addressed at which levels. However, such a catalogue would be at odds with the design of current EU multilevel governance (Swenden, 2004) and would contradict increased heterogeneity of Member States after enlargement. However,

by smoothing the implementation of subsidiarity and clarifying the division of tasks – also for EMU – the CT improves legitimacy.

Competences regarding EMU fall into the following categories: Monetary Policy and the conclusion of international agreements (with regard to the euro) fall under the exclusive competence of the Union for the Member States, whose currency is the euro. While the Union may legislate and adopt legally binding acts under the exclusive competence, the Member States may do so only if so empowered by the Union or for the implementation of Union acts.

The CT lists economic policy coordination as a separate category of competences. With regard to economic governance member states shall coordinate their economic and employment policies within the Union, with specific provisions applying to those Member States, whose currency is the euro. The coordination shall take place within arrangements that are determined by Part III of the CT, which the Union shall have competence to provide. Here, the role of the Union is determined by the Member States, with the Member States clearly asserting their sovereignty in this area. These provisions fall short of the ambition of some to complement Monetary Union with an economic pole.

Furthermore, the CT knows a flexibility clause, under which the Council can unanimously extend the powers of the EU in the areas covered by Part III, i.e. thus also with regard to EMU, if action by the Union proves necessary to attain one of the objectives set out in the CT. With this provision the boundaries of multilevel governance in EMU could be moved more easily. In the Nice Treaty such a flexibility clause (Art. 308 TEU) applied only to provisions regarding the Common Market.

3. Decision-Making: Procedures and Institutions

Efficiency and effectiveness of decision-making shall be evaluated according to voting procedures and thresholds for QMV and the extension of qualified majority voting (QMV) compared to Nice as well as the working methods of the EU institutions. In future, efficiency may be improved with the introduction of new institutional functions, namely a President of the European Council and of the Eurogroup, as well as with a smaller Commission college and giving the Commission President more power within the Commission. The implementation of the CT will clearly lead to a certain *personalisation* of the European Union. Improved working methods and a clarification of competences between the Ecofin and the Eurogroup might bring more leadership and continuity into multilevel economic governance.

3.1 Voting and Extension of QMV

The CT brings about a radical change in the Council of Ministers' voting procedure. The main difference of the CT-voting system to the Nice Treaty-voting system[5] is the abolition of the weighting of votes and the introduction of the *double majority system*.

Discussions on the voting system in the Council of Ministers accounted for the greater part of the negotiations in the Intergovernmental Conference (IGC) on the institutional chapter. Spain and Poland held out against the double majority principle introduced already by the Convention draft text, which recommended that qualified majority should consist of half the States representing three-fifths or 60% of the population. Spain and Poland objected: they wanted to keep the weighted votes of the Treaty of Nice, which strengthened the blocking capacity well beyond their real demographic weight (so-called "Aznar-bonus"). It was also this dispute that led to the adjournment of the IGC at the Brussels European Summit in December 2003.

The agreement finally reached by the IGC retained and incorporated the principle of double majority into the Constitutional Treaty abolishing the weighting system of Nice. The new system represents a radical change in the Council's voting procedures, but these new voting procedures will only apply from November 1, 2009 onwards.

Although both, the Convention and the IGC, aimed to clarify and simplify the decision-making systems, the new voting system presents itself – as many compromises especially with small Member States had to be taken into account – as complicated and doubts about efficiency have already arisen. Furthermore, the postponement of the new voting system until November 1, 2009 is regarded by some analysts as a failure to solve the enlarged EU's decision-making challenges. This failure will have important consequences as the next five years will – under the Nice Treaty rules – determine how efficiently the enlarged EU works and how it is perceived to function (Baldwin and Widgrén, 2004a).

Under the CT a qualified majority is defined as *at least* 55% of the members of the Council comprising at least 15 of them and representing Member States comprising at least 65% of the population of the Union (Article I-25 (1)). To get

[5] According to the voting system of the Nice Treaty, which is in force since November 1, 2004, three criteria have to be met for decisions to be adopted:

1. A qualified majority threshold of 169 (EU-15) or 255 (EU-27) votes (71.31% and 73.91%, respectively, and a blocking minority of 69 or 91 votes).
2. A simple majority of Member States; if the Council does not act on the initiative of the European Commission, agreement by at least two thirds of Member States is mandatory.
3. The qualified majority must represent 62% of the entire EU population (this will be verified on request only).

the backing of the smaller Member States, which wanted to draw the two thresholds closer, the threshold for the number of Member States is expressed both as a percentage and as quantity; the qualified majority (i.e. the 55% threshold) must comprise at least 15 Member States (which in the EU-27 amounts to 55.56%). This initiative was mainly driven by Austria, Finland and the Czech Republic at the very end of negotiations.

The IGC finally gave up the idea of not taking abstentions into account when calculating the total number of Council members and the population. In that case the qualified majority would still have required 55% of the remaining Member States representing 65% of the population.

For a decision under *super-qualified-majority* 72% of the Member States representing 65% of the population of the Union will be required. This system applies when the Council is not acting on a proposal from the European Commission or the Union Foreign Minister, i.e. in cases of recommendations from the Commission or recommendations from the ECB on EMU matters.

A *blocking minority* must include at least four Council members, failing which the qualified majority shall be deemed attained. This means that the second threshold, based on demography, is accompanied by a quantitative criterion: the 35.01% of the population forming a blocking minority will have to come from at least four Member States. This would prevent the large countries (e.g. Germany, France and Italy) from blocking the adoption of a legal act. On the other hand, no minimum demographic threshold was adopted for the coalition of the 15 (or more) Member States needed to block a decision. This compromise maintains the double majority principle, reassures the small Member States about their potential influence, and addresses the concerns of Spain and Poland.

To further complicate the new voting system, the Constitutional Treaty – in particular on Poland's insistence – reintroduces a formula inspired by the wording of the Ioannina compromise of March 1994, on the eve of enlargement to fifteen Member States. This appeal clause states, that if three-quarters of Member States or three-quarters of the population required to block a decision have been placed in a minority position, they may request suspension of the decision to debate it in the European Council. This Ioannina-compromise will take effect – as part of the new voting system – on November 1, 2009 and will no longer apply after 2014, unless the Council extends it by qualified majority. This provision is an additional complicating factor, which seems to counteract the intended efficiency (Grevi, 2004).

Measuring the efficiency of the voting system and its impact on the influence of groups of Member States is very difficult. First analyses differ in their outcomes. According to mathematical simulations of Baldwin and Widgrén (2004), this new double-majority voting system offers the possibility of 12% of *winning coalitions*, i.e. coalitions capable of approving an issue, compared to 2% with the Treaty of Nice voting system (Baldwin and Widgrén, 2004a). As Kurpas and Crum (2004)

point out, this system ensures that *constructive majorities* can be organised more easily and it limits the scope for taking certain policies *hostage* in order to get better benefits in other, not related areas. On the other hand, the last-minute adaptations to the double majority voting system ensure that at least four countries have to reject a decision, thus avoiding dominance of large member states. The double majority voting system will also be more adaptable to future enlargements by not having to negotiate weighted votes for new member states on an ad hoc basis. However, adaptations to the CT's voting rules regarding future enlargements might be politically unavoidable.

Others are more critical. Grevi (2004) points out that the new voting rules are more complicated and that higher thresholds make decision-making less efficient. Vaubel (2004) argues that the new voting system will increase the danger that those Member States, which are more strongly regulated, will force their higher level of regulation upon the more liberal ones in order to deprive them of competitive advantages. This would in turn lead to an even further increased level of regulation.

However, as the Nice Treaty voting system has been in force since November 1, 2004, the *real* (in-)efficiency of these rules can be measured only in a few months time. Only then an assessment and a comparison with the Constitutional Treaty voting rules can seriously be undertaken.

The biggest progress concerning *efficiency* may be the agreement that except when the CT provides otherwise, the Council will reach decisions by qualified majority vote. Thus, the Luxembourg Compromise, i.e. a Member State’s right to prevent a decision from being taken in the Council, is scrapped entirely.

In EMU current practice already requires a qualified majority in the Council for a large part of decisions. The CT does therefore not provide for a significant extension of the scope of qualified majority voting in EMU: So far, the Council has been able to amend the ESCB/ECB Statutes on a recommendation from the ECB and by qualified majority. An amendment proposed by the European Commission would have required unanimity in the Council. The Constitutional Treaty lays down that the Council decides on a proposal from the European Commission by qualified majority and on a recommendation from the ECB by super-qualified majority. This slightly strengthens the position of the European Commission vis-à-vis the ECB. The President, the Vice-President and the other members of the Executive Board of the ECB are appointed by the European Council, now acting by a qualified majority.

The IGC reintroduced the *passerelle mechanism*. This clause provides for movement from unanimity to QMV and from the special legislative procedures to the ordinary legislative procedure for areas covered by Part III on the basis of a unanimous decision of the European Council with the consent of the European Parliament. However, the objection of one national parliament will be sufficient to

block such a move. Thus, the possibility to move further toward qualified majority voting seems to be somewhat restricted.

3.2 Improved Working Methods

3.2.1 Ecofin Council and Eurogroup

The Council of Economic and Finance Ministers (Ecofin Council) has been convening since the late 1950s, but its status was greatly enhanced with the onset of EMU.

The CT introduces two changes for the Ecofin of the enlarged Union:

With regard to improved working methods of Council formations the Convention originally intended a system of *Team Presidencies*, which the CT has only preserved nominally. Therefore, the Ecofin Council will in principle be presided over by groups of Member States. Three Member States in rotation will chair the Ecofin – as well as the other Council configurations – for a period of 18 months. In fact, the system of rotation every six months is preserved; the country holding the presidency will be assisted by the other two of the team on the basis of a common programme. The CT has thus included the outcome of the Seville European Council in June 2002, which sought better coordination and mutual support over a longer period of time in managing Council proceedings by preparing a joint programme by the current, past and future presidencies of the Council. As there is in fact no change in working procedures, efficiency gains are negligible in this context.

With regard to institutional balance, the Ecofin loses several decision-making competences to the Eurogroup. The Eurogroup, has been gathering since June 1998 in addition to the Ecofin Council as an informal body composed by the Ministers of Member States whose currency is the euro. The Eurogroup discusses about fiscal policy, the common currency and the external representation of the euro area.

Even before the CT, discussion about an upgrading of the Eurogroup's status was present at the academic as well as at the political level. Already in the beginning of the 1990s France had called for a *gouvernement économique* as a counterweight to the ECB. At this time, especially Germany opposed this plan. In spring of 2001, France repeated the call for an economic government. Commission President Romano Prodi also spoke out in favour of establishing a *genuine economic governance*. According to the 12 finance ministers of the Eurogroup at this time, economic policy coordination should be intensified further, but there was no need for an official economic government and a harmonized economic policy. But there was a common understanding among the euro area Ministers, that in an enlarged Union the Eurogroup would gain a higher profile, as the Ecofin Council

would be less suited to take decisions on the euro area given the increase in member states with a derogation.

However, the Amsterdam and Nice treaty revisions did not come up with any initiative to formalize the Eurogroup, because at that time – with a Union of 15 Member States – there was practically no need for change. In the course of the Convention, it was again France, this time supported by Germany, which came up with the initiative of *formalizing* the informal Eurogroup. The proposals of the Convention to introduce a specific regime for Euro area Member States were enhanced by the IGC, as a result of strong pressure from group Member States, motivated by enlargement and the wish to discuss euro area matters more in depth among the *Club Members*.

Although the Eurogroup continues to meet informally, the Constitutional Treaty defines a number of new provisions which only apply to euro area Member States and areas of responsibility in which only euro area Member States have the right to vote.

- In order to ensure the proper functioning of EMU the Eurogroup can decide with qualified majority on measures to strengthen the coordination and surveillance of budgetary discipline within the euro area and set out specific economic policy guidelines for the euro area provided they are compatible with the Broad Economic Policy Guidelines (BEPG) of the Union.
- In order to secure the euro's place in the international monetary system the Eurogroup can decide by qualified majority on common positions to be taken within institutions and international financial conferences, as well as take steps to ensure unified representation within these institutions and conferences.
- Furthermore, it is the exclusive responsibility of the Eurogroup to conclude agreements on an exchange rate system for the euro or general orientations for the exchange rate policy vis-à-vis non-euro area currencies. The same holds for decisions on the euro central rates within the exchange rate mechanism (ERM II). The Eurogroup shall also decide the arrangements for the negotiations and for the conclusion of such agreements on exchange-rate matters with countries or international organizations.
- With regard to the abrogation of derogations after the convergence assessment the Council decides by qualified majority, after consulting the European Parliament, after discussion in the European Council and on a proposal from the European Commission. New is that this decision is to be based on a recommendation from the euro area Member States, acting by qualified majority. The Eurogroup has the first *say* on the accession of new countries to EMU. The final decision on the irrevocable fixing of the euro rate is taken by unanimous decision of the Eurogroup and the Member State concerned.

- Provisions on EMU that do not apply to Member States with a derogation include furthermore the objectives and tasks of the ESCB/Eurosystem, issue of the euro, the legal acts of the ECB, measures governing the use of the euro and the appointment of members of the Executive Board of the ECB.

With regard to institutional balance the CT gives a higher profile to the euro area by introducing a neater distinction between members of the euro area and the Ecofin, whose influence in euro area matters becomes more marginal. These provisions confirm the evolution of an integration core group in EU economic governance (*centre of gravity*). On the one hand continuity and leadership in policy making will be enhanced and efficient working methods may be developed by a more permanent president of the Eurogroup, who very likely may become a trusted and esteemed dialogue partner for the ECB Governing Council. This *personalisation* will also lead to a strengthened role of the Eurogroup compared to the Ecofin Council, but probably also vis-à-vis the ECB/Eurosystem and its Governing Council. On the other hand institutional competition and a reinterpretation as well as a search for new roles of different policy actors may also increase with the higher profile given to the Eurogroup. In general, economic governance will become more complex chiefly by strengthening the Eurogroup.

3.2.2 The European Council

The CT establishes the European Council as an institution that is separate from the Council of Ministers; the European Council is to meet quarterly to provide impetus to the Union's development and to set political directions and priorities. The European Council will be headed by an appointed President as soon as the CT enters into force. The introduction of a non-rotating Presidency of the European Council was the main institutional demand of France and the United Kingdom. The President will be appointed for a term of two and half years, renewable once. He or she may not hold a national mandate and the Convention's idea of allowing scope for a merger of the posts of President of the European Council and of the Commission has been maintained (Barbier, 2004). The President will have limited powers with regard to coordination of work among the EU institutions and shall be in charge of the Union's external representation, in particular. Pursuant to the CT he or she would have hardly any internal competences, but could gain considerable influence indirectly, via the circle of Heads of State and Government (Di Fabio, 2004). In general, the success or failure of this important new function will largely depend on personalities (Grevi, 2004).

With regard to EMU, the European Council plays an important role in economic policy coordination. Inter alia, the European Summits decide on the Broad Economic Policy Guidelines (BEPG), structural labour market reforms according

to the Employment Guidelines (EG), the implementation of a balanced macroeconomic policy mix, the improvement of the Single Market and the implementation of the Lisbon Agenda. The CT reaffirms the framework of economic policy coordination and also the role of the European Council.

3.2.3 The European Commission

As regards the size and composition of the European Commission, the IGC substantially altered the Convention's draft text. The Convention provided for just 15 full Commissioners, assisted by non-voting Commissioners. This ambition to limit the number of Commissioners in the interest of efficiency and effectiveness was vigorously opposed by the smaller Member States, each of which wanted to ensure it could nominate a Commissioner. The compromise provides for the continuation of the current system of one Commissioner per Member State until 2014. Then the number of Commissioners should be limited to two thirds of Member States, with representation on the principle of a strictly equal rotation, unless the European Council decides otherwise, acting unanimously. A declaration annexed to the Constitutional Treaty, at the request of Sweden, insists that this restricted composition must guarantee that Member States not represented in the Commission must be kept fully informed.

The President of the European Commission will in future be proposed by the European Council to the European Parliament acting by a qualified majority and taking into account the result of the elections to the European Parliament. This candidate shall then be elected by the European Parliament by a majority of its component members. The Council, by common accord with the President-elect, shall adopt the list of the other persons whom it proposes for appointment as members of the Commission. They shall be chosen on the ground of their general competence and European commitment and their independence shall be beyond doubt. The President, the Union Minister for Foreign Affairs – also Vice President of the Commission – and the other members of the Commission shall be subject as a body to a vote of consent by the European Parliament. On the basis of this consent the Commission shall be appointed by the European Council, acting by a qualified majority.

The Constitutional Treaty strengthens the role of the President of the European Commission: it underscores his or her authority to determine policy guidelines, it strengthens his or her right to dismiss Commissioners, and it emphasises his or her accountability vis-à-vis the European Parliament (Di Fabio, 2004).

As regards its role in EMU, the CT did not strengthen the Commission. As compared to the Convention's draft text, the Commission's role with regard to the Excessive Deficit Procedure has even been diminished. Council decisions on recommendations with regard to excessive deficits will be based on a Commission

recommendation and not – as the Convention had proposed – on a proposal from the Commission.

3.2.4 European Parliament

During the Convention, but especially during the IGC, there was a long dispute among the EU Member States over the future size of the European Parliament. Finally, its size was fixed at 750 members, slightly higher than the 736 seats envisaged by the Convention.[6] A minimum and maximum number of seats for each member state is also identified – respectively 6 and 96. Within these limits, a unanimous decision of the European Council will establish – based on a proposal of the European Parliament – before 2009 the actual distribution of seats by country, taking into account those countries that will have joined the Union at that point (that is expected to be at least Romania and Bulgaria).

The CT strengthens the role of the European Parliament by establishing the co-decision procedure as the standard legislative procedure of the Union. Furthermore, the standard legislative procedure is greatly simplified: references to Commission proposals and the co-decision procedure are replaced by simply mentioning the law or framework law in Part III, which provides for the Policies and Functioning of the Union.

Furthermore, the European Parliament has attained a stronger position in appointing the European Commission: in future the European Parliament has the right to elect the President of the European Commission instead of just voting in consent on a proposal by the European Council. In general, this provision fosters democratic legitimacy in the Union. It strengthens both, the European Parliament within the EU institutional set-up, but also the President of the European Commission, vis-à-vis the EU Member States as well as vis-à-vis his/her cabinet of Commissioners.

Under current provisions the role of the European Parliament in EMU is a very limited one. At most, the European Parliament's scrutiny of the macroeconomic co-ordination mechanism serves a function of *publicity* in its literal sense: the European Parliament provides a public place where the different processes of warning, recommending and reviewing can be collated and compared, with the possibility of awkward questions being asked about equality of treatment and diligence of follow-through (Hodson and Maher, 2001). Monetary policy is still more exogenous to the politics and powers of the European Parliament than the trans-governmental economic co-ordination mechanism (Lord, 2003). The European Parliament's role under the present treaties is confined to reporting rights. However, the European Parliament decided to put a maximal interpretation on its treaty rights and to deploy them cumulatively. Thus it billed consultations on

[6] At present, the EP has 732 seats.

the appointment of the first executive board of the ECB as *confirmation proceedings* (European Parliament, 1998). Each nominee was required to return written answers to a standard questionnaire and appear in person before the Economic and Monetary Affairs Committee (EMAC) of the European Parliament. During the *confirmation hearing* the European Parliament reached successfully an agreement with the then incoming ECB President, Wim Duisenberg, that regular hearings before the EMAC would be held every three months. Thus, the European Parliament, successfully established a monetary dialogue with the ECB, by means of *intelligent* interpretation of the treaties. For instance, there is no change in the legal provisions with regard to accountability. Moreover, the ECB's relationship with the European Parliament is regarded as more than just a matter of policy efficiency and public relations. The ECB's own pronouncements suggest it sees important legitimation benefits out of the working procedures with the European Parliament (Lord, 2003).

The CT, in principle, confirms the working procedures and rights of the European Parliament under the present treaties and does not fundamentally change its role in EMU. However, the European Parliament will be able to influence multilateral surveillance more strongly, as this procedure will have to be set down as a European Law, where co-decision will apply.

4. Economic Policies in Operation: Institutional Balance, Efficiency and Effectiveness

4.1 Monetary Policy under the Constitutional Treaty

The Convention barely touched upon monetary policy issues and the Constitutional Treaty does not entail any changes in substance in this area compared to the current legislation; most amendments were of a technical nature only and involved mainly a reorganization of chapters in the Treaty. Monetary policy provisions come under the constitutional Part I as well as under the more operative Part III, which can be amended by a simplified revision procedure.

With regard to the euro area the CT brings about several important innovations. First and foremost, the CT recognizes the *Eurosystem* as well as the Eurogroup , introduces a longer-term chairman of the Eurogroup (Protocol) and incorporates the definition of the euro as the currency unit of the Union.

The Constitutional Treaty lists the ECB as *an other Union institution*. When the institutional structure of the ESCB had been defined by the Treaty on European Union, the ECB had deliberately not been classified as an institution of the Community. As the CT does not list the ECB among the political institutions, such as the Council, the European Commission or the European Parliament, the

ESCB/Eurosystem presumes that the ECB is an institution sui generis and that the new institutional classification of the ECB does not imply any substantial change.

The CT defines the concept *ESCB* and, for the first time, also the concept *Eurosystem*[7]. The Eurosystem comprises the ECB and the national central banks (NCBs) of the Member States which have adopted the euro. The ESCB is governed by the decision-making bodies of the ECB (the Governing Council and the Executive Board) and pursues the primary objective of maintaining price stability. Without prejudice to this objective, it supports the general economic policies of the Union to contribute to the realization of the Union's objectives. The ECB has the exclusive right to authorize the issuance of banknotes. Primary legislation now stipulates that the currency of the Union is the euro, which is also listed under the symbols of the Union.

While the Treaty on European Union emphasizes the independence of both the NCBs and the ECB[8], the CT only refers to the independence of the ECB: in exercising its functions and in administrating its funds the ECB is independent. The Community institutions, bodies and other agencies as well as the governments of the Member States respect this principle of independence. The independence of the NCBs is only stipulated in Part III.

All other tasks of the ESCB are defined in Part III of the Constitutional Treaty and in the ESCB/ECB Statute. The Constitutional Treaty also states that the ECB has legal personality. The section on *monetary policy* describes the objectives and tasks of the ESCB and stipulates the ESCB's primary objective of maintaining price stability.

Furthermore, the sections on monetary policy and the ESCB/Eurosystem have been reorganized, i.e. the transitional provisions no longer include the provisions that referred to the European Monetary Institute (EMI), the second stage of EMU and the beginning of the third stage of EMU. And, as mentioned before, the specific provisions for the euro area countries are summarized in a separate section. The general institutional provisions on the Governing Council and the Executive Board of the ECB as well as on the participation of the President of the Council of Ministers, i.e. Eurogroup President, in Governing Council meetings, the participation of the ECB President in Ecofin Council/Eurogroup meetings and the relations between the ECB and the European Parliament have been moved to Title VI, "The Functioning of the Union".

The institutional framework of monetary union as embodied in the Treaty on European Union has been reaffirmed; it works along lines of distinct allocation of powers and in the absence of conflicts over sovereignty. Here, the Maastricht Treaty created a supranational structure, i.e. the ECB and the ESCB, with clear

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[7] The Governing Council of the ECB has used the term Eurosystem in its external communication since 1998.

[8] Article 108, Treaty on European Union.

competencies and objectives. The tasks, mandate, status and legal and institutional framework of the ECB, Eurosystem and the ESCB remain, therefore, practically unchanged. Thus, as regards the monetary constitution of the CT, an enlarged Union is well prepared to act in a transparent way with a clear attribution of competencies and objectives.

4.2 Coordination of Economic Policies under the Constitutional Treaty

4.2.1 Economic Governance and Coordination

The Convention's Working Group on Economic Governance failed to come out with a progressive approach to strengthen or *communitarise* economic governance. The idea of granting additional powers to the Commission and involving the European Parliament more closely in the decision-making process did not reach a consensus within the Convention. Only few modifications were made by the Convention, e.g. giving more weight to the Commission in implementing the Broad Economic Policy Guidelines and in the Excessive Deficit procedure. These provisions had been challenged in September 2003 by the Informal Ecofin Council in Stresa, as the demands of several Member States were taken into account by the IGC.

As a consequence, EU/euro area economic governance as provided for by the CT remains based on three elements, entailing minimal harmonisation of *public policy requirements* (Micossi, 2002):

- A single monetary policy conducted by the ECB/Eurosystem, whose primary objective is to maintain price stability. Without prejudice to this objective the ESCB shall support the general economic policies in the Union in order to contribute to the achievement of the Union's objectives. (*Supranational Institution*)
- Decentralised budgetary policies guided by the provisions for an Excessive Deficit Procedure and – outside of the Treaty – the Stability and Growth Pact. (*Hard Coordination*).
- Multilateral surveillance of economic policies, which Member States shall regard as a matter of common interest entrusted to the Ecofin and the European Council. (*Soft coordination*); The Broad Economic Policy Guidelines remain the main instrument of economic policy coordination.

A fourth element, that of the *open method of coordination* for structural policies remains outside the CT.

The CT provisions for multilateral surveillance and the Broad Economic Policy Guidelines (BEPG) remain largely unchanged in comparison to the Treaty of Nice. The only innovations are, that the vote of the Member State, whose economic policy is not consistent with the Broad Economic Policy Guidelines, is not taken into account and the Commission may in this context address a warning directly to the Member States. Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council. However, as already mentioned, the Eurogroup is given the competence to adopt specific measures to strengthen the coordination in order to ensure the proper functioning of EMU.

Stability is reaffirmed as the overall principle for economic governance activities of the Member States under EMU shall entail compliance with stable prices, sound public finance and monetary conditions and a stable balance of payments.

This development is not surprising. The issue of strengthening economic policy coordination within the euro area is one of the most politically contested and sensitive issues in EMU (Dyson, 2002). In the past, discussions of economic policy coordination involved mostly budgetary policies of Member States and their consistency with the Stability and Growth Pact as well as the Broad Economic Policy Guidelines and the contested issue of "macro economic policy coordination". Institutional competition happened vertically between Member States and the Commission and horizontally between the ECB/Eurosystem and the Eurogroup. These debates mirrored very clearly unresolved questions of sovereignty and institutional balance.

Two main reasons may be identified, why there was no movement to deepen economic policy coordination in the CT: first, six years of EMU have shown that the present ex post approach to macro economic policy coordination works rather well and second, different normative approaches to EU/euro area economic governance exist among Member States, which have been, in addition, sharpened by enlargement.

On average, since the start of EMU, both, monetary and fiscal policies followed a neutral path, fostering growth in an environment of low inflation. Some critics blame the Stability and Growth Pact and a monetary policy too much focused on the goal of price stability as having had a key role in limiting growth in aggregate demand. This critique does not hold up with the facts. First, between 2000 and 2003 euro area nominal public sector deficits deteriorated by close to 2% of GDP, mostly reflecting the cushioning impact of automatic stabilisers and with that helped to stabilise the business cycle. Monetary policy generated interest rates at unprecedented low levels, with short term real interest rates averaging 1.1 % compared to 3.3 % in the previous decade. Second, constrained private demand throughout the last few years, both in private consumption and investment, is not

related to macroeconomic policies but reflects uncertainties about the sustainability of fiscal policies and the way structural policy reforms are implemented.

Furthermore, critics of ex post coordination hold that ex ante policy coordination at a euro area level could improve a sustained commitment to national reform policies and relieve the ECB from the excessive burden of being viewed as the sole policy actor within the area (Jacquet, Pisany-Ferry, 2001). Indeed, the heavy process of coordination in comparison to the very efficient decision-making in the ECB Governing Council could translate into greater institutional pressure for monetary adjustment (Lindner, Olechowski, 2002); but there have been no incidents in the past six years to prove such a hypothesis so far and the CT provides for a much clearer perception of the responsibilities of the euro area and the Eurogroup.

Different normative and causal beliefs, about how EU/euro economic governance are based on differences in size, economic structure, level of economic development and political preferences of Member States. The French are prone to stress the role of interventionist states in shaping markets through stronger and formal economic policy coordination; others are more likely to stress the role of social partners (Dyson, 2002). Enlargement is likely to deepen this heterogeneous approach in the EU-25.

On the other hand reduced heterogeneity in the Eurogroup may make innovations in euro area economic policy easier. For the relationship between fiscal and economic policies on the one hand and monetary policy on the other this could translate into less pressure for monetary adjustment.

EU economic policy coordination among member states will continue to take different forms, involving shared goals, but no vertical coordination among different macro economic policy areas. In the areas of hard and soft coordination rules and procedures are subject to erosion and reinterpretation according to developments in economic policy, the bargaining power of policy actors (Micossi, 2002) and increasing ambitions to extend coordination to all aspects of economic and social policies via the Open Method of Coordination. Though, some critics hold that the costs of such an extended and complex coordination may be higher than its gains (Breuss, 2002).

From a Union point of view developing EU/euro area economic governance is not a stand-alone project. Many political and academic observers hold, that it requires strong political fundamentals in the sense of a closer political union. Indirectly, it is therefore important for economic governance that the CT leads to significant progress in the general governance of the Union, with for example integrating the areas of freedom, security and justice as well as the Common Foreign and Security Policy (CFSP) into the Treaty.

4.2.2 Coordination of Fiscal Policies

Neither the Convention nor the IGC touched upon a reform of the policy framework concerning the coordination of budgetary policies. The budgetary policy framework remains almost unchanged in the CT.

As compared to the Convention's draft text, the Commission's role with regard to excessive deficit procedures has been diminished. Council decisions on excessive deficit reports, along with the related recommendations, will be based on a Commission recommendation. The Council will be able to adopt this recommendation according to *super-qualified majority* voting, without unanimity being required to amend it.

The only change to the present situation is, as was proposed by the Convention, that the Commission addresses an opinion to a Member State where an excessive deficit exists or may occur. At the next stage, as is currently the case, the Commission will only have right of recommendation (and not as proposed by the Convention, a right of proposal, which would in effect necessitate a unanimous vote in the Council to alter the content of a Commission proposal). As it is already the case in the current Treaty, the Council will be composed by all the Member States but at this stage the Council shall act without taking into account the vote of the member of the Council representing the Member State concerned. Coercive means of remedying excessive deficits will as at present be adopted by the Ecofin Council comprising only those Member States, whose currency is the euro; the Member State concerned will not take part in the voting.

Against the background of the Ruling of the European Court of Justice on the suspension of the Stability and Growth Pact on July 13, 2004 the IGC decided that the jurisdiction of the European Court of Justice in excessive deficit procedures are now explicitly limited in the Constitutional Treaty to procedural rather than funding aspects. In the IGC, especially the Netherlands has sought to re-establish full powers for the Court, but Germany was opposed to full reinstatement. By way of compensation, a declaration was annexed to the Constitutional Treaty stressing the importance of strict respect of the Stability and Growth Pact and inviting Member States to consolidate budgetary reserves during periods of growth.

The Eurogroup has recently improved its own working methods, this may in turn lead to more efficient fiscal policy coordination within the Eurogroup and indirectly to further improvement in the ex post outcome of the macro economic policy mix. Moreover, as already mentioned, the CT may strengthen the core role of the Eurogroup also in fiscal policy coordination.

Although – or perhaps because of - there are only minor changes in the CT, discussions about the fiscal framework in the Union and the strengthening of economic governance, in particular the Stability and Growth Pact (SGP), continue. The EU coordination framework for economic policy has been perceived as focusing predominantly on budgetary balances and fiscal discipline, while the link

between guidelines on economic policies and recommendations for fiscal policies has been weak. In the opinion of the European Commission, this has led to a loss of credibility and ownership and, ultimately, to institutional uncertainty at the European level. Since then several ideas have been tabled to improve the implementation of the SGP (European Commission, 2004), which are currently under discussion and may lead – what the CT did not achieve – to an enhancement of fiscal policy coordination. The current President of the Eurogroup and the Ecofin Council, Juncker, plans to present an SGP reform proposal to the European Council in March 2005.

4.2.3 Open Method of Coordination

The Lisbon European Summit in March 2000 introduced a new Open Method of Coordination (OMC), which was intended to support the implementation of the Lisbon strategy and its objectives. Since that the OMC has been extended to cover an enormous range of policy fields, e.g. taxation and pensions. Beyond the Broad Economic Policy Guidelines (BEPG) introduced by the Maastricht Treaty in 1992, and the European Employment Strategy (EES) introduced by the Amsterdam Treaty in 1997, the OMC has been intended to become a central tool of EU policymaking. As part of the *Lisbon Strategy* the Lisbon European Council authorized the extension of the OMC to a host of other policy areas, namely also structural economic reform. OMC is controversially assessed: on the one side it is seen as a new mode of EU governance (Héritier, 2001) suitable for addressing common European concerns while respecting national diversity, which pushes Member States to exchange information and compare themselves to one another. On the other side, OMC has been criticized as a vehicle for the EU to encroach illegitimately into policy domains reserved entirely to Member States, but conversely also as a threat to European integration through binding legislation; above all, the most widespread criticism of OMC concerns its lack of impact on Member States, with regard to the implementation of the Lisbon Agenda.

Thus, not surprisingly, although on the agenda of different Convention Working Groups[9], none of them came out with the proposal to incorporate the OMC into the CT. Instead, the CT gives the Union general powers to coordinate the economic, employment and social policies of the Member States and allows the EU to take *supporting, coordinating or complementary action* in other areas without harmonizing Member States' laws or regulations. Part III of the CT then sets out specific procedures for the coordination of national policies in different areas, incorporating the existing treaty provisions for the BEPG and the EES.

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[9] E.g. the Working Groups on Economic Governance, Simplification, Complementary Competencies (renamed supporting measures) and Social Europe.

The CT confirms, what some academics forecast, namely that there is an overall bias against conferring more powers to Community institutions in economic policy coordination and against a *hardening* of coordination and in favour of the open coordination method (*soft* coordination) emerging as a policy mode in its own right (Dyson, 2002).

Thus, the CT put its stamp of approval on the present coordination framework, by adopting most of its parameters. However, it is not unlikely that political imperatives and institutional adaptation may in the future allow for progress in making the EU policy coordination system more efficient and less cumbersome and costly. In this sense, deeper political integration may hold the key to improve EU policy coordination and also better economic performance (Ioannou et al., 2004).

4.3 External Representation of the Euro Area

At present, the international financial community does not regard the euro area as a single actor in international financial institutions and conferences to, such as IMF, World Bank, G7, G10 or G20.

Within the IMF, numerically speaking, the EU or the euro area could dominate decision-making[10]; in practice, this is frequently foiled as Member States fail to coordinate a common position to be held in the Executive Board. There is no clear perception of a euro area responsibility and the euro area had only a minimal influence on the debate on international financial architecture within the IMF; financial rescue packages of the IMF were heavily contributed to by the EU/euro area, but the field of operational influence was left to the U.S.A. (Bini-Smaghi, 2004; Portes, 2004).

In the absence of a single EU/euro area constituency, the EU has set up a typical system of multilevel governance where EU/euro area member states, the ECB and to a small extent also the European Commission coordinate action within the IMF. The principal elements of common actions are an IMFC statement by the Ecofin President, the adoption of EU common understandings on IMF policy issues, coordination of action by the EU representatives in the IMF and the organization of Art. IV surveillance over the euro area’s monetary and exchange rate policy (Kiekens, 2003). However, there are many shortcomings: commitment to common

[10] The members’ or constituencies’ quotas (capital subscriptions) determine their voting powers in the IMF Executive Board. At present, the U.S.A holds the largest capital subscription, namely some 17.50%, and thus also has a blocking minority for decisions taken by the Executive Board of the IMF. The EU does not have a country member status; however, the combined calculated quota of euro area Member States: amounts to 23.30%. The combined quota of an EU-25 would edge up to about 32.40% (EU-27: 33.20%).

positions is sometimes only weak; coordination among G7 is often more effective and far-reaching than among EU countries, interaction between G7 and EU coordination efforts may create confusion. On the other hand, on matters of private sector involvement and a Sovereign Debt Restructuring Mechanism the EU adopted quite different positions from those of the U.S.A.

In fact, in the run up to the Constitutional Treaty debates in Convention working groups reflected the dissatisfaction with current informal arrangements for representing the euro area in international organizations like the IMF. However, discussions in the Convention were inconclusive.

The Constitutional Treaty now provides for the Eurogroup to establish common positions on matters of particular interest for EMU within the competent international financial institutions and conferences and to adopt appropriate measures to ensure unified representation within the international financial institutions and conferences. The Eurogroup takes votes with and acts upon a proposal from the Commission after consulting the ECB. Furthermore, monetary agreements, other measures and general orientations with regard to exchange rate policy for the euro in relation to third countries may be agreed upon by the Eurogroup. In these cases the Eurogroup acts unanimously and consistently with the objective of price stability. The Eurogroup may act on a recommendation from the ECB or the European Commission after consulting the ECB.

The only new feature of these provisions is, that they shift decision-making on common positions, unified representation and exchange rate agreements from the Ecofin to the Eurogroup. On the one hand unified representation of the EU within the IMF is now likely to arise out of the euro area and by common action of the euro area Member States and not the Union itself. On the other hand the concept of unified representation is left vague and will only happen, when the political will of the Eurogroup emerges.

What could be the motivation behind putting the Eurogroup into the driving seat of improved external representation? One reason might be that only euro area Member States have effectively transferred monetary sovereignty to the Union level, thereby making the euro area responsible for complying with the most important commitments of its member states under the IMF's Articles of Agreement. Another reason might be, that the prevailing opinion is, that only *countries* can become members of the IMF (Kiekens, 2003) and that an appropriate reinterpretation of the term *country* within the IMF Articles of Agreement would be too difficult to achieve, anyway. (Although the EU has now a single legal personality under the CT and could thus act and be held accountable on the international scene).

As a consequence, in the area of external representation the Constitutional Treaty shifts the institutional balance from the EU-25 to the Euro-12. On a technical and coordination level the allocation of competences and influence stays intransparent and will continue to lead to confusion and shortcomings. It remains to

be seen, whether efficiency and effectiveness of external representation may increase, because of improved working methods of the Eurogroup itself. The longer-term Eurogroup chairmanship might, indeed, increase efficiency of decision-making and effectiveness of implementation beyond the area of euro area Article IV consultations. With regard to institutional balance, efficiency and effectiveness the Constitutional Treaty made only marginal progress in giving the Union and its Member States a clear and solid framework for its role in international economic and monetary governance.

5. Conclusions

The debate about an effective and enlarged Europe within the Convention and also within the IGC was focussed on values, efficiency, effectiveness and legitimacy of the institutional architecture. Representing a new and consistent legal architecture, the Constitutional Treaty is also intended to enhance and streamline decision-making in an enlarged Union, both at the European and the international level. However, changes fall short of really enhancing the EU's role as a global economic player.

EMU is an integral part of EU and one of the most integrated poles and developing euro economic governance is not a stand-alone project. It also requires strong political fundamentals in the sense of a closer political union; indirectly, it is essential for economic governance that significant progress is made in the general political governance of the Union. With integrating into the CT the areas of freedom, security and justice as well as the Common Foreign and Security Policy (CFSP) an important step has been taken into the right direction.

With regard to EMU, the most important institutional innovations are brought about in the euro area, whose profile reflects that of a *centre of gravity* of integration. First and foremost, the Constitutional Treaty recognizes the *Eurosystem* as well as the *Eurogroup*. With regard to institutional balance the CT gives a higher profile to the euro area by introducing a neater distinction between members of the euro area and the Ecofin. Within the euro area the balance in multilevel governance might be shifted slightly by a more permanent president of the Eurogroup.

The institutional framework of monetary union as embodied in the Treaty on Europe has been reaffirmed; it works along lines of distinct allocation of powers and in the absence of conflicts over sovereignty. Here, the Maastricht Treaty created a super national structure, i.e. the ECB and the ESCB with clear competencies and objectives. The CT does not entail any changes in substance in the field of monetary union compared to the current legislation; most amendments were of a technical nature only.

Furthermore, in future, continuity and leadership in multilateral economic governance may be improved with the introduction of new institutional functions,

namely a President of the European Council and the Eurogroup, as well as with a smaller Commission college and giving the Commission President more power within the Commission. The implementation of the CT will clearly lead to a certain *personalisation* of the Union.

The CT approved the present economic policy coordination framework. The budgetary surveillance framework remains almost unchanged. And as the Open Method of Coordination (OMC) is confronted with contradictory assessments since its formal introduction as working method in the EU at the Lisbon European Summit, it was not surprising, that neither the Convention nor the IGC put forward new proposals for a more effective implementation of measures under OMC. There is only a very limited strengthening of the role of the Commission in economic coordination, falling short of the Commission's ambitions. However, it is not unlikely that political imperatives and institutional adaptations may in future allow for progress in EU policy coordination. In this sense, deeper political integration may hold the key to improve EU policy coordination and also better economic performance.

At present it is difficult to gauge whether the CT has improved the efficiency of the decision-making process of the Council, and thus of the Ecofin Council. Arguments pro and contra are inconclusive. On the one hand first evaluations hold that under the new system "constructive majorities" are more probable, the scope for national vetoes is limited, in general the QMV rule applies and the new voting system is adaptable to further enlargement without negotiations. On the other hand critics hold that due to the many compromises made, the new voting rules have become more complex and therefore less efficient. The introduction of the *double majority system* represents a radical change in the Ecofin Council's voting procedures, but an assessment – with regard to sufficient efficiency for an enlarged EU – in comparison to the Nice Treaty provisions can only be seriously undertaken once the rules have been in operation for some time.

Also with regard to efficiency and effectiveness of multilevel governance, the CT introduces a potential degree of flexibility into EMU provisions: with the introduction of the simplified amendment procedure it slightly relaxes the rigidity of the present Treaty amendment process for EMU provisions, on the basis of a flexibility clause the Council can unanimously extend the powers of the EU also with regard to EMU. Finally, it remains to be seen to what extent the European Council will make use of the newly created possibility of widening the scope for majority decisions in the Council in cases where the Treaty provides for unanimity, although this possibility seems somewhat restricted by the procedures (*passerelle mechanism*) involved.

The CT reflects the Union of today and represents the maximum that could have been achieved politically. However, it will still face hurdles on the road to ratification. Implementation of the CT is very desirable, as it will contribute to better leadership and continuity in the EU. Although complexity of multilevel

(economic) governance is hardly reduced, a more coherent architecture and improved political fundamentals may enhance overall efficiency and effectiveness.

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Comment on Isabella Linder and Marlies Stubits: "A Constitutional Treaty for an Enlarged Europe: Are there Fundamental Changes for EMU?"

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In this presentation I will try to briefly outline the complex set up of institutions of the Constitutional Treaty. In the Constitution the intergovernmental method has clearly prevailed and even gained importance.

The Constitution has modified the provisions of the European Council and has enhanced its role in many ways. One example would be the introduction of a so-called European Council President, which will be elected for a term of two and a half years.

With regard to the ECB/ESCB system, I would like to point out that the ECB is placed under the heading *The other institutions and advisory bodies* of the Constitution and the *Eurosystem* is now formally mentioned and defined. Part I of the text establishes price stability as a major objective of the Union. Interestingly, the draft Constitution of the Convention did not name price stability as one of the Union's objectives. This seems to be a good example of the lobbying power of the ECB/ESCB. During the Intergovernmental Conference it succeeded in integrating price stability in the final text of the Constitution not only as an objective of the ESCB, but for the Union as a whole. An article in the ECB's Bulletin of August 2004[1] describes the ESCB's role in the Intergovernmental Conference. Apart from the independence of the ESCB, which prevails, it is also interesting to note that it should coordinate the monetary policy not only of the *ins*, but also of the *pre-ins*.

The formal recognition of the Eurogroup adds an additional element to the system of economic policy coordination. The fact that the Eurogroup will also have specific competences could lead to a stronger role of the Eurogroup vis-à-vis the ECB and to potential conflicts with the Ecofin-Council. The President of the

[1] ECB Bulletin (2004),The European Constitution and the ECB, August, pp. 51-64.

Eurogroup is already elected before the Constitutional Treaty enters into force, but lacks a legal basis. From January 1 the Prime Minister of Luxembourg Juncker will, together with his Vice-president the Austrian Minister of Finance Grasser, preside over the Eurogroup for a term of two years.

Compared to accountability procedures for central banks in the USA and the UK the Constitution does not emphasize the accountability of the ECB to a sufficient extent. Article 383 of part III of the Constitution merely states that the ECB President presents the Annual Report to the European Parliament.

The European Commission had many ambitions during the Constitutional process, but, in the end, its position was not substantially strengthened. It is still the European Council that de facto elects the President of the European Commission. A candidate is proposed by the European Council to the European Parliament which confirms or rejects the candidate. If rejected the European Council decides on a new candidate and the procedure is repeated. In EMU the position of the Commission practically has not changed.

With the elected President of the European Council, the President of the Eurogroup and the double headed foreign minister, the number of players representing the EU on an international level has increased and coordination will be challenging.

The central element of economic policy coordination remains the Economic and Financial Committee. It is a highly influential expert-committee that brings together the representatives from Member States, the ECB and the European Commission and prepares the meetings of the Ecofin-Council and the Eurogroup.

A substantial part of the literature stresses the very small gains in policy-coordination. Maybe the complex and cumbersome coordination-processes in EMU may even outweigh these gains.

Financial Stability Arrangements in Europe: A Review

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1. Introduction

> "*Few regard the current institutional structure as fully satisfactory or in a final state. The obscurity surrounding the legal position of the ESCB, the principle of subsidiarity, and the difficulties of agreeing loss sharing amongst separate national (fiscal) authorities all militate towards leaving the onus for supervision and crisis handling at the national (NCB) level. Logical tidiness and the likelihood of increasing externalities (overspills), as financial interpenetration within the EU gathers pace, suggest greater centralization.*" *(Goodhart, 2000, p. 11)*

"May you live in interesting times." Banking regulators and supervisors in the European Union may at times be reminded of this doubled-edged Chinese saying. EU expansion, deepening financial integration, monetary unification among a subset of Member States, the trend towards large-scale cross-border mergers and the substantial changes likely to be wrought by Basle II, supervision II, International Financial Reporting Standards (IFRS), and International Accounting Standards (IAS) all pose important challenges to the traditional nationally based system of supervision.

The gauntlet has been taken up. Though (often separate) national supervisory agencies for banking, insurance and securities markets remain the norm, the

[1] We would like to thank Karin Hrdlicka for very helpful comments. Many thanks also to Eduard Hochreiter, Hans-Helmut Kotz, and participants at the Workshop and at the March 2004 SUERF seminar on *The Future of Regional Insurance Companies* in Graz; as well as to Haizhou Huang, Paul Kupiec, Thordur Olafsson and Jan-Willem Van der Vossen for discussions. Disclaimer: The paper reflects the personal opinion of the authors and not necessarily of the institutions they are affiliated with.

European supervisory system has become substantially internationalized through harmonized minimum standards, extensive information-sharing networks and cooperation; generally following and building upon the guidelines proposed by the Basel Committee and other coordinating bodies.[2]

Yet a host of questions and challenges remain. Looking forward, will the current system of co-ordinated national (sectoral) supervision remain equal to its task as EU-level financial institutions gain in importance? Or do increasing integration and more prevalent cross-border spillovers demand discrete institutional adjustments, in particular the creation of a multi-lateral supervisor? Should any multi-lateral supervisory agency retain the traditional split between *insurance*, *securities* and *banking* or be integrated across financial market areas?

Does the loss of national monetary autonomy for the Eurozone members imply particular urgency for this group? If so, should the supervisory and the monetary policy function be combined in the ECB or split into the central bank and a separate financial supervisory agency? In either case, how should Lender of Last Resort (LOLR) functions and burden sharing arrangements be handled?

These questions have been subject to a lively and sometimes controversial debate involving academics, public officials and bankers. The discussions, dating back to the early 1990s, pit proponents of greater integration and centralization against advocates of a more localized approach. We hope that this paper, which reviews and discusses some of the challenges in the European banking system in greater detail, contributes to the search for a consensus. We begin with a brief presentation of recent trends in cross-border activity in banking and insurance before turning to the challenges and potential solutions in the areas of supervision and crisis management.

2. How Important Are Pan-European and Multi-Sector Financial Institutions?

The importance of institutional reform depends on the degree to which the formerly national financial markets have evolved into a true European financial market with multi-national financial institutions, and, related, on the importance of cross-border spillovers and externalities. A sizable literature explores both the state of integration and possible causes of border effects:[3]

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[2] The Basel Committee guidelines include the Basel Concordat (1983), The Supervision of Cross-Border Banking (1996), Core Principles for Effective Banking Supervision (1997) and Supervision of Financial Conglomerates (1999). On the insurance side, the International Association of Insurance Supervisors' Core Principles for Insurance Supervision aimed to harmonize standards.

[3] Recent comprehensive studies include Hartmann, Maddaloni and Manganelli (2003), Baele, Ferrando, Hördahl, Krylova and Monnet (2004), Manna (2004) and Reszat (2004).

- Do national banks increasingly take on international business or risk?[4]
- Are prices and returns converging?[5]
- How important are legal and institutional restrictions?[6]

While a full exploration of these issues would take us far beyond our core topic it is worthwhile to highlight some trends brought out by the literature for the specific area of banking. First, cross-border merger and acquisition (M&A) activity in banking remains robust but is smaller than intra-national (M&A)[7]. Only a small fraction of cross-border deals result in integrated structures operating under a single brand name in multiple markets. Second, wholesale banking markets appear to be substantially more integrated than retail markets, which appear to be subject to significant border effects. Beyond the home bias, proximity effects seem to be secondary (Manna, 2004).

Third, EMU does not as yet appear to have led to a marked increase in integration levels or trends; aside from a (pre-adoption) interest rate convergence, in particular visible for government bond yields. Fourth, while multi-sector financial institutions, notably banking-insurance combinations are gaining in prominence, the traditional core sector tends to remain dominant in these institutions. Finally, as a partial exception to these trends, foreign ownership stakes in the new member countries are substantially higher.

Most critical reviews of the evidence correspondingly find European financial markets to remain far from integrated. Philip Hartmann, Angela Maddaloni and Simone Manganelli (2003) conclude that "In the area of retail banking the increased homogeneity of interest rates seems to be driven more by macroeconomic convergence than by market integration. For example, cross-border loans to non-banks have somewhat increased but remain a very small fraction of total lending. This is quite different in wholesale activities, as inter-bank lending jumped up with the introduction of the Euro and banks' cross-border security holdings also expanded considerably. While the strongly domestic bias in the consolidation strategies of European banks has only changed very mildly recently, and while the single European passport to create foreign bank branches seems not to be used very much, it is interesting to report the observation that in the U.S.A, too, cross-state penetration by banks still remains quite limited.*"*[8,9]

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[4] See Buch (2001), Buch and DeLong (2002), Manna (2004).

[5] See e.g. Danthine, Giavazzi and von Thadden (2000) and Hartmann, Manna and Manzanares (2001).

[6] See Danthine, Giavazzi, Vives and von Thadden (1999).

[7] Dermine (2003). See Berger et al. (1999, 2000, and 2003) and Buch and DeLong (2002) on the economics of bank mergers and consolidation.

[8] Hartmann, Maddaloni and Manganelli (2003).

Looking at the same issue from the banker's perspective, Emilio Botin, Chairman of Grupo Santander, expresses a similarly skeptical view in evaluating promising strategies for European banks: "Another alternative, which is widely discussed these days, is a large cross-border merger, especially between European banks. Some believe, perhaps with an eye on the success of big U.S. mergers, that the movement towards greater integration in the European Union makes such cross-border mergers advisable in our continent. I am very skeptical about the merits of this strategy. It will be some time before Europe is sufficiently integrated and the many barriers – regulatory, fiscal and cultural – that impede the functioning of the single market are overcome. "[10] A related view is expressed by the European Financial Services Round Table (EFR, 2003, p.1*):* "The European Financial Services Round Table believes that the lack of harmonization of supervision and regulation is an important obstacle to the development of cross-border financial services."

3. Supervision

The current system of harmonized supervision reflects the gradualist approach pursued since the 1970s. The underlying philosophy aims to combine harmonization (in terms of minimum standards) with flexibility for national authorities to complement minimum measures by steps reflecting national idiosyncrasies in institutional and market structures. National measures are subject to mutual recognition.

Major advances along this route include the first Banking Co-ordination Directive of 1977 specifying the definition of a credit institution and the criteria for granting a banking license; the 1983 directive on carrying out consolidated supervision; the 1986 rules on account harmonization, the 1989/1993 2nd Banking Co-Ordination Directive establishing home control; the 2000 EU directive relating to the taking-up and pursuit of the business of credit institutions introduced a single EU bank license as well as a number of other measures on issues ranging from deposit insurance to the own funds, solvency ratio and large exposures directives.[11] Further progress to integration is expected from the implementation of the *Financial Services Action Plan* (FSAP) agreed at the Lisbon Summit. The FSAP sets out reforms in the areas of financial law, regulation and taxation. The forty-two individual measures are scheduled for implementation by 2005.

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[9] Schoenmaker (2003) reaches a similar conclusion: "Summing up, the process of integration of 15 national financial systems is not yet completed. While wholesale markets are generally largely integrated …. Retail markets are still largely fragmented within the EU."

[10] Botin (2004).

[11] See Hadjiemmanuil (1996) for a detailed discussion.

Implementation of supervision remains at the national level. Foreign subsidiaries are supervised under the principle of consolidated solvency supervision by the home country authority, but are also subject to individual (non-consolidated) supervision by the host country. Branches are solely supervised by the home authority for solvency purposes, with the host authority having a supervisory function in liquidity matters.

National control is augmented by extensive co-operation and co-ordination. The Eurosystem is charged (Art. 105(5)) with contributing "to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" and enjoys a consultative and advisory role in the rule making process (Padoa-Schioppa, 1999).

3.1 Domestic Supervisory Arrangements

The traditional arrangement in which banking supervision (and banking supervision only) was undertaken by the central bank has been re-examined from two angles over the last two decades. A first line of inquiry focuses on whether continued cross-sector integration renders the traditional sectoral focus of supervision obsolete, an issue taken up in the 1999 guidelines of the Basel Committee on the Supervision of Financial Conglomerates. A second line of inquiry examines the desirability of the monetary authority also having supervisory responsibilities.

3.2 Sectoral Versus Integrated Systems

While arrangements remain diverse, the last decade has witnessed a shift from de jure separate supervisors in the banking, insurance and securities sectors to de jure integrated supervisors, following the proposal of the Lamfalussy group. Twelve Member States, including Germany and the United Kingdom, have chosen to unify financial supervision in a single agency; while eleven Member States, including France and Italy, retain a specialized banking supervisor. Two states, Finland and Luxembourg, combine banking with one other sector for supervisory purposes.

These de jure institutional differences are likely to overstate the practical divergence as de facto integration has proven difficult; reflecting differences in the underlying motivation for regulation (systemic risk versus consumer protection), in the types and extent of regulations, and not least the typical specialization and separation of the supervisors themselves present obstacles to operational integration.

Table 1: Institutional Arrangements for Financial Market Supervision in EU Countries

Unified supervisory agency	**Banking supervision integrated with one other supervisory area**	**Specialized banking supervisor**	**Specialized insurance supervisor**	**Specialized securities supervisor**
Austria	Finland (I)	Cyprus (CB)	Cyprus (G)	Cyprus (SA)
Belgium	Luxembourg (S)	Czech Republic (CB)	Czech Republic (SA)	Czech Republic (SA)
Denmark		France (CB,AS)	Finland (SA)	France (SA)
Estonia		Greece (CB)	France (SA)	Italy (SA)
Germany		Italy (CB)	Greece (G)	Lithuania (SA)
Hungary		Lithuania (CB)	Italy (SA)	Poland (SA)
Ireland (CB)		Poland (CB)	Lithuania (SA)	Portugal (SA)
Latvia		Portugal (CB)	Luxembourg (SA)	Slovakia (SA)
Malta		Slovakia	Poland (SA)	Slovenia (SA)
Netherlands(CB)		Slovenia (CB)	Portugal (SA)	Spain (SA)
Sweden		Spain (CB)	Slovakia (G)	
U.K.			Slovenia (G)	
			Spain (SA)	

Note: B,I,S — Banking, Insurance, Securities supervision. Italics identify countries in which the national central bank remains fully or partially responsible for banking supervision. CB: supervision by central bank. G: supervision by government department, SA: supervision by supervisory agency. Source: Grünbichler and Darlap (2003 and web pages of national central banks and supervisory agencies).

3.3 Central Bank Involvement

> *"The Eurosystem strongly supports a continued involvement of national central banks in prudential supervision, although the institutional set-up of financial supervision needs to be tailored to the structure of the respective national financial system." (Duisenberg, 2002).*[12]

The supervisory role of the (national) central bank presents a second area of institutional differences. An evolving debate explores the desirability of allocating

[12] Duisenberg (2002).

supervisory authority to central banks.[13] Arguments for a separate agency include the potential for conflicts between monetary policy objectives and financial stability objectives; arguments in favor of retaining a formal role for the central bank focus on synergies and information sharing, notably with respect to maintaining a smoothly functioning payment system.

In EU members retaining a separate banking supervisor, the central bank is the overwhelming candidate to fulfill this role, though the potential conflict between monetary policy and financial stability objectives does not arise in the case of the EMU members France, Greece, Italy, Portugal and Spain. On an operational level, close cooperation between the central bank and the supervisory agency – including cross representation at the respective boards – remains the rule even in countries with unified supervision in a separate institution outside the central bank.

The ECB does not have formal responsibility for prudential supervision. However, under Art (105 (6)) it can be given such tasks without a treaty amendment, leaving open a relatively straightforward avenue towards a merger of the monetary policy and the supervisory function on the ECB level should such an expansion of responsibility be desired at a future time (Hadjiemmanuil, 1996).

3.4 Supervisory Co-ordination

Table 2: Fora for Formalized European Co-operation in Banking and Insurance Supervision

	Banking	**Insurance**	**Securities**	**Conglomerates**
Level 2 Regulatory Committees	**EBC** European Banking Committee	**EIC** European Insurance Committee (includes Pension Funds)	**ESC** European Securities Committee	**FCC** Financial Conglomerates Committee (FCC)
Level 3 Supervisory Committees	**CEBS** Committee of European Banking Supervisors	**CEIOPS** Committee of European Insurance and Occupational Pensions Supervisors	**CESR** Committee of European Securities Regulators	

Source: Grünbichler and Darlap (2003).

While the primary supervisory authority resides at the member state level, in practice supervision incorporates an extensive multi-lateral component operating

[13] See Hadjiemmanuil (1996), Eijffinger and de Haan (1996), Eijffinger (2001), Duisenberg (2002), García Herrero and del Río (2003) and Grünbichler and Darlap (2004) inter alia. Di Giorgio and Di Noia (2002) discuss a more disaggregated structure distinguishing between microeconomic stability; investor protection and proper behavior; and efficiency and competition.

through a network of coordinating bodies.[14] The three-level structure comprises on the first level the Ecofin Council and the Parliament setting the broad framework. On the second regulatory committees vote on proposals of the European Commission for technical implementation measures; while level 3 committees advise the European Commission on "level 2 measures" and promote the consistent implementation of EU directives as well as the consistent implementation and convergence of supervisory practices. While the institutional structure includes a level 2 (and an optional level 3) committee on financial conglomeration, the current setting is primarily focused on sector-specific supervision.

Operating within this framework, as well as in broader multilateral groups, consistency of supervisory practice across Member States has markedly improved in recent years. Yet more work remains to be done. In a recent analysis focusing on the EMU area, Padoa-Schioppa (2003) concludes that "The EU and the Euro area are now very far from this (unified) standard. Supervisory reporting requirements and rulebooks still differ markedly between countries" (p. 298). Speaking from the banker's perspective, Anton van Rossum, CEO of the Dutch/Belgian Fortis Group, takes a similar view: "Integration of the European financial markets makes the economy grow. […] European cross border banks and insurers are helping this integration by offering their customers a more pan-European product range, promoting pan-European best practices and having by definition a less protectionist attitude. But our cross-border activities are hampered by different sets of rules and supervising mechanisms. These hurdles block potential benefits."[15] Recent reviews of banking supervision in individual EU countries in the context of the International Monetary Fund's Financial Sector Assessment Program (FSAP) reach similar conclusions.[16]

3.5 Looking Forward

> *"International competition among bank regulators will not, in general, be efficient when regulators maximize national welfare, lenders are unable to monitor bank behavior, and there are foreigners among the lenders and/or bank owners whose preferences are not taken into account by the regulators."* (Sinn, 2003, p. 173).

[14] The structure of these groupings has itself responded to ongoing developments. It was substantially modified in 2004, roughly along the lines of the Lamfalussy framework covering European Securities Supervision.

[15] Cited in release by the Insurance Journal, Europe's Banks and Insurers Appeal for Regulatory Harmonization", October 29, 2003: www.insurancejournal.com/news/newswire/international/2003/10/29/33618.htm

[16] For examples of assessments see http://www.imf.org/external/np/rosc.

If initiatives aimed at reducing border effects in financial markets succeed in creating a true European financial market, will the current arrangement of harmonized national supervision augmented by cross-border co-ordination remain best suited to address future challenges? Should it be replaced by a *European System of Financial Supervisors* structured along the lines of the ESCB? If so, should it cover all sectors or be sector-specific? If sector-specific, should the central agency be the ECB itself or a separate body? Should it cover all banks, or only banks exceeding a specified threshold in terms of cross-border activity?

These questions have been explored since the early 1990s, as yet with no clear consensus. An active literature explores the more general issue of whether national supervision remains efficient in an integrated financial market, as well as the more specific EU concerns.[17] The tenor of the literature is skeptical on the longer-term merits of combining national supervision with the objective of an integrated EU financial market, pointing out a number of potential problem areas:

3.6 Inference Problems:

Even with information sharing arrangements, is the national supervisor likely in practice to have access to all relevant information, specifically, will a national supervisor be able to identify problems arising from the interaction of smaller problems in different foreign locations, each of which by itself may not be viewed as problematic?

3.7 Supervisory Competition Problems:[18]

Are there incentives that will lead to competition between supervisors to produce less costly (but socially sub-optimal) de facto supervision, in particular in light of the new flexibility introduced with Basle II?

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[17] Recent contributions include Prati and Schinasi (1999), EFC (2000), Lannoo (2000), Belaish, Kodres, Levy and Ubide (2001), Vives (2001), Acharya (2003), Dalen and Olsen (2003), Dell'Ariccia and Marquez (2003), Schoenmaker (2003), Holthausen and Rønde (2004).

[18] See Sinn (2003).

3.8 Incentive Problems:[19]

Will cross-country differences in the incidence of the costs and benefits of a supervisory action (for example, the allocation of the cost of deposit insurance, bailouts or indeed bank failures) lead to decisions that are optimal from a national but not the aggregate perspective for banks that have important foreign operations?

The first problem area is least intractable, and is addressed through the system of information sharing reviewed above. The second and third areas are more fundamental. To the extent that such problems do arise, the case for a multi-lateral supervisory agency for multi-national banks that internalizes the externalities is strengthened; though the traditional approach of harmonization may also go a long way in addressing specific issues.

While an EU level supervisory agency eliminates some of the externalities that will potentially plague the current system as cross-border activity grows in importance; moving to a multi-lateral agency also carries significant disadvantages and may encounter obstacles. First, practicing supervisors emphasize the benefits of proximity between the supervisor and the supervised; a proximity that would be negatively impacted by a move to an EU level supervisory agency. The argument of course loses strength to the extent that the very process of enhanced cross-border activity erodes the role of the headquarter as an information hub. Second, some decisions by an EU-level supervisor, in particular a bank closure, carries potentially sizable fiscal implications for the Member States.

These difficulties notwithstanding, the longer-term evolution of supervisory arrangements points in one direction. If supervisory arrangements in the EU were newly created today, it is very unlikely that the current system would be chosen: efficiency considerations suggest matching the spatial purview of the supervisory agency with the spatial business purview of the supervised banks to reduce externalities.

The optimal transition arrangement from the current system to a multilateral supervisor is far less evident. Should it be revolutionary, transferring supervisory authority proactively from national to a new EU supervisory agency? Or should it be evolutionary – retaining the current system with a continued emphasis on the harmonization of practices with a gradual evolution of the current coordinating bodies into the nucleus of a future EU supervisory agency; with a full functional

[19] Along these lines, Holthausen and Rønde (2004) show that in the case of banks with foreign branches, adherence to the guidelines of the Basel Committee would not necessarily lead to full sharing of *soft* (non balance sheet) information for a closure decision if the home and host country supervisor have different interests, reflecting, for example, a different systemic importance of the bank in the two countries. Sinn (2003) explores the consequences of foreign depositors and foreign bank equity holders on the decision making process of a national regulator in the context of international competition.

transfer and the creation of an institutionalized EU supervisory agency coming at the end of a potentially quite extensive transition phase?[20] Should it cover all banks, or be initially limited to banks exceeding set thresholds in terms of size and international orientation; with national supervisors retaining authority for the remaining banks?

In our view, a number of factors argue for a gradualist approach initially focusing only on the small subset of banks that can be truly described as multinational:

- The case for a multi-lateral supervisor rests on the importance of cross-border activity, spillovers and externalities. As reviewed above, the fully integrated European (retail) banking system however remains a distant goal.
- The potential problems identified in the theoretical literature notwithstanding, the current system of national supervision determined by the headquarter location augmented by extensive coordination and information sharing has a strong track record.
- In the near future European banking and insurance concerns will experience substantial change in the wake of Basle II, Solvency II, ongoing and planned revisions to International Accounting Standards (IAS) and other changes. Prudence argues against undertaking large changes in supervisory arrangements with their unavoidable initial hiccups in a period already presenting supervisors with substantial challenges.

Conversely, however, the ability of the current system to cope with these changes provides a test case for their quality. The Basel II agreement enhances the discretion of national banking supervisors to assess relative risk while the *Solvency II* framework currently worked out for the European Insurance industry proposes a capital framework based more directly on individual companies' risk profile.[21] Given the differences in national practices rooted in the historical idiosyncrasies, enhanced discretion carries the possibility that standards will be differently applied across EU Member States. Whether the proposed measures to

[20] While no such transfer is currently envisaged, the political tussle regarding the location for meetings of the Level II and Level III committees suggests expectations of greater future importance.

[21] Solvency II is a two-phased project aimed at reviewing the European framework for the prudential supervision of insurance companies and establishing a solvency system that better matches the true risk profile of insurance undertaking than that of the present system. The full implementation of Solvency II will need to await the implementation of International Accounting Standards Board (IASB) new guidelines. The timeline for the full implementation of Solvency II remains open.

ensure consistent implementation[22] will prove sufficient to cope with these challenges will influence the debate on the need and timing for institutional reform.

An evolutionary approach also appears appropriate regarding the sectoral unification of supervision. Experience over the last years suggests that the de facto integration of sectoral supervision is a difficult and long-term task proceeding far beyond their de jure placement under a single task.[23] Given these practical difficulties, undertaking both sectoral and cross-border integration at the same time appears over-ambitious relative to an approach emphasizing increased information sharing between sectoral supervisors while reserving decisions about institutional formats for a later point. For the same reason, it appears prudent to delay any decision on the formal role of the ECB in an eventual multilateral supervisory arrangement and instead to focus on improved co-ordination within the level 2/3 framework.

4. Crisis Management

Beyond the challenges of day-to-day supervision, financial integration raises important issues for the prevention of financial crises and the structure of the crisis management framework. Crisis prevention is based on effective supervision, effective early warning systems, and an appropriate "prompt corrective actions" framework. In the emerging European context, crisis prevention will depend critically both on the effectiveness of the supervisory coordination outlined above, and on a speedy agreement on the measures to be taken to isolate the institution and avoid a further spillover of the problem. The informational and incentive problems reviewed above thus arise in this context as well.

If a crisis cannot be prevented, crisis management assumes center stage. In the EU context, crisis management, depending on the nature of the troubled institution may have to involve (i) differently structured national supervisory agencies, (ii) national central banks with sharply differing scopes for LOLR actions, (iii) national treasuries (some restrained by the stability and growth pact) and (iv) the ECB. As integration proceeds, this complex system is likely to encounter operational difficulties.

Compared to the gradual but steady progress made in adjusting supervisory arrangements to the process of European financial integration, crisis response arrangements have undergone less formal institutional adjustment; and remain the subject of spirited debate. Two recent reports on financial security commissioned

[22] For details see press release of the 2471st ECOFIN Council meeting of December 2, 2002.

[23] A recent reorganization of the Financial Services Authority (FSA) enhancing the focus on systemically important institution bears witness to an evolution of supervision even in a technically unified setting.

by the Ecofin Council ("Brouwer I", 2000 and "Brouwer II", 2001) examine the crisis management capabilities of the current system. The reports take an overall optimistic tone, but emphasize the need for further improvements, notably in information sharing arrangements. This has been taken up in the March 2003 multilateral Memorandum of Understanding (MOU) between the ECB, the EU and national central banks and financial regulators.[24] The MOU, which complements and partially replaces the existing web of bilateral MOUs, sets out principles for the scope and mechanisms of cross border cooperation and the distribution of responsibilities in crisis management situations as well as information sharing arrangements and logistical arrangements. In other areas, such as the identification of a lead institution, it is less specific. As the financial system evolves, these arrangements must be revisited and reassessed. The following paragraphs take up some of the pertinent issues.

4.1 Deposit Insurance and Guarantee Schemes

The objectives of EC Directive 94/19/EC of May 1994 regarding the harmonization of deposit insurance schemes have been substantially achieved.[25] The insurance schemes are generally seen as adequate; consequently there has not been a strong push for the establishment of a multi-lateral system (Schüler, 2003). That said, some potential problem areas exist, in particular regarding the responsibility of the home country deposit scheme for liabilities arising in foreign branches.

In contrast to the banking (and the securities) sector only a few EU Member States have explicit insurance guarantee schemes in place. While the absence of such schemes creates additional challenges if an insurance company has to be wound down, systemic effects of insurance company failures are less likely given the different nature of insurance sector liabilities.

4.2 Lender of Last Resort Function I: Actors

The arrangements for lender of last resort functions (and more generally the issue of a lead institution) have been the subject of spirited debate. The split of the 25 EU Member States into twelve countries sharing a common central bank, two countries with permanent opt-out rights and eleven countries headed for eventual adoption of the Euro raises a number of tricky issues. Under current arrangements, supervision and LOLR functions remain on the same level: national central banks

[24] See ECB (2003).

[25] See Garcia (2000) and, for the case of the accession economies, Nenovsky and Dimitrova (2003).

will provide LOLR assistance to systemically important institutions within their jurisdiction.

For the EMU members, the capacity for monetary LOLR actions is however limited, turning attention to the role of the ECB. While the Maastricht Treaty does not grant the ECB a formal LOLR function, it opens the door to support actions through the responsibility for the payment system. Market expectations seem to view such actions as likely in case of systemic problems: the "absence of a euro area wide institution that would be able to put together a rescue package at a moment's notice implies that the ECB might have to keep the Euroland financial system afloat in the event of a major financial accident." (Morgan Stanley, 2002). The likely de facto emergence of the ECB as a LOLR in cases of systemic crisis raises the question whether such a role should not be pre-specified in order to reduce uncertainty (Goodhart, 2000, Vives, 2001). Importantly, this debate is not so much about the principal capacity or even willingness of the Eurosystem to respond to a crisis, but rather about the desirability of specifying arrangements ex ante. In the longer term, an evolving debate concerns the desirability of shifting the responsibility for bailouts to a separate, fiscal agency.

4.3 Lender of Last Resort II: Burden Sharing

Two issues arise in the allocation of costs of LOLR actions. First, the traditional allocation of costs to the country in which the institution is headquartered becomes problematic as EU-wide operating banks headquartered in smaller economies become more prevalent. Second, the treatment of the often-sizable fiscal costs of such operations under the SGP requires clarification.

4.4 Lender of Last Resort III: Coverage

Under current arrangements, the immediate response to a possible crisis situation differs depending on the type of institution (initially) affected. While troubled banks would be considered for a monetary LOLR operation by the national central banks, other financial institutions, or financial conglomerates not led by banks, would have to look towards an industry organized life-boat operation or to a direct budgetary bailout. As the trend towards closer cross-sectoral integration of financial institutions continues, and as, in consequence, the possibility of cross-sectoral financial crisis transmission rises, this traditional allocation of potential access to LOLR operations requires reconsideration.

5. Conclusion

The process of financial integration is fluid, as must in consequence be the supervisory and crisis management responses. In many areas, the most pertinent question is not so much *what*? but rather *when* and *how*?

On supervision, the final destination is clear. As the long held objective of a true European financial marketplace is realized, the supervisory arrangements must likewise adapt from the national to the European level (at least for the top tier of multi-national banks) to reduce negative externalities. The optimal timing of the transition is less clear. Moving immediately to integrated multi-lateral supervision has distinct advantages in terms of consistent information gathering and the reduction of potential problems from competing standards and different incentives. Yet such a revolutionary move also has significant drawbacks. Our assessment favors a continuation of the current cautious *evolutionary* approach, with a gradual transfer of supervisory authority to the EU level, plausibly taking place within the current set of co-ordinating bodies.

On crisis management, the challenges are different. One can reasonably envisage scenarios in which problems of a large bank headquartered in a smaller member over-stretch the capacity of the national central bank. One can equally imagine circumstances in which taxpayers in a particular Member States are unwilling to bear the entire burden of supporting a bank active in multiple Member States. While such problems would likely be addressed in an ad hoc and case specific manner, the absence of a well-defined structure creates potentially detrimental and counter-productive uncertainty. In our view the case for further clarification of crisis management policies and burden sharing is strong.

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Comment on Anne-Marie Gulde and Holger Wolf: "Financial Stability Arrangements in Europe: a Review"

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1. Introduction

In discussing Anne-Marie Gulde's and Holger C. Wolf's paper regarding *The Institutional Setting for Financial Stability in Europe*, I would like to start with recalling the first headline of the presentation: "May you live in interesting times". On my opinion, this sentence fully characterises the current discussion about the future institutional setting for financial stability in the European Union.

Even though this discussion is not new and has only recently led to the introduction of the so-called Lamfalussy-approach in the securities field (2001) and then in all financial services sectors, over the recent months the discussion process has again gained momentum. The main reasons have been highlighted in the paper: the EU enlargement and the introduction of the euro, the financial integration process, Basel II with its more qualitative and process-based approach and the International Accounting Standards (IAS). In addition, the issue of efficiency and effectiveness of supervision became increasingly important.

The paper provides a very good analysis of some of the challenges emerging from these structural and regulatory developments, and a number of interesting suggestions are put forward in this respect. In providing comments, I focus at first on the analysis of current trends in the banking sector and then on supervisory issues; last but not least, I have a few comments on the issue of crisis management.

2. Structural Trends

In the paper, a number of trends in the banking sector have been highlighted, which indicate that European Financial Markets are not yet fully integrated. This is

clearly an important fact, given that it implies that national specificities are still of importance and need to be appropriately addressed.

In addition, I would like to mention some further observations which might be relevant in this context:

Firstly, cross-border activities of banks have become increasingly important, which is particularly true for the new EU Member States, where on average nearly 70% of banking assets are controlled by foreign banks, mostly from other EU countries.

Secondly, major banking groups have continued to reorganise their activities, driven by search for increased efficiency. This has on one hand led to the centralisation of certain functions on banking group level, for example risk management and liquidity management; on the other hand, other lines of business, in particular support activities, have been outsourced outside the group.

Thirdly, some banking groups could consider adopting the new European Company (SE-) Statute and transforming their subsidiaries into branches. So far, there are no indications that the SE-Statute would be widely adopted, but it is clear, that this would have major impact from a supervisory perspective, in particular in case of systemic relevant branches, and lead to a shift in supervisory responsibilities from the host country to the home country.

Whatever the institutional supervisory setting looks like, it seems clear that these three issues require a close monitoring, some sort of common approach and supervisory co-operation.

3. Supervision and Regulation

3.1. Current Institutional Setting

Before analysing the proposals for the future institutional supervisory setting, it might be useful to briefly summarise the main elements of the current supervisory arrangements. Most of them have also been mentioned in the paper:

3.1.1 National Responsibility for Banking Supervision

In principle, banking supervision is a national responsibility and conducted by national supervisors. In the paper, the differences in the national supervisory arrangements have been pointed out, which relate mainly to sectoral versus integrated supervision and whether the central bank is involved or not. As regards the latter, several types of involvement are possible, and in fact, in the EU-25 there are only three cases where there is no central bank involvement in banking supervision at all.

Moreover, in the Netherlands another concept has recently been added to this variety of arrangements, based on a *functional* or *horizontal* distinction between prudential supervision on one hand and conduct-of-business supervision on the other hand. Prudential supervision is the task of the central bank.

These differences indicate that there is no *best supervisory system*, but that besides historical reasons for different solutions, each country has to find a system which optimally fits into its general framework in terms of acceptance, effectiveness and economic benefit. This has to be kept in mind when any suggestions for a single supervisory system on EU level are considered.

3.1.2 Harmonisation of Certain Minimum Standards and Mutual Recognition

As regards the second principle, a number of EU-directives have created a common regulatory framework based on the principle of minimum harmonisation. In the paper, the EU passport was mentioned in this context. This passport, which has already been introduced in 1989, allows each bank licensed in and supervised by a Member State to conduct its business in all other Member States, either through a branch or through providing cross-border services. In addition, with a view to subsidiaries, the concept of consolidated supervision is a key element, since it ensures an overall perspective over the banking group.

3.1.3 EU/EEA Co-ordination and Co-operation

Finally, as regards the third principle, co-operation and co-ordination arrangements have been established on bilateral and multilateral basis. In this respect, the level 2 and level 3 committees under the so-called Lamfalussy-approach are of particular importance. Further, with a more macro-prudential focus, co-operation between central banks and banking supervisors also takes place in the Banking Supervision Committee of the European System of Central Banks (ESCB). These committees are embedded in a complex supervisory and regulatory framework.

3.2. Challenges for Supervision

3.2.1 Future Supervisory Arrangements

So far as with regard to the current supervisory arrangements. In the paper it is argued that "if supervisory arrangements in the EU were newly created today, it is very unlikely that the current system of *national supervision plus* for all banks would be chosen over alternative two-tier arrangements with a multi-lateral agency supervising banks above some size and internalization threshold, and national

supervisory agencies retaining responsibility for smaller banks operating primarily in their domestic market."

In this respect, I have a number of comments and questions:

First, and most importantly, I think that the suggested approach bears a high risk of divergent developments of supervisory rules and practices. This could further lead to a potential distortion of local market level-playing fields, given that large and small banks would be subject to different supervisory regimes. However, they would continue to carry out their activities in the same local markets. Different rules and reporting schemes would also make it difficult to ensure an overall assessment of the development of the respective national financial market. Therefore, my question is how a consistency of rules and practices could be ensured?

Second question: How and at which level should the decisive threshold be defined? If it is low, there could be a risk that the central supervisor will soon be overburdened, which might have negative effects on the quality of supervision and finally, on financial stability. Further, if a bank extends its cross-border activities, from my understanding it could suddenly happen that it would be subject to a different supervisory regime, which would not only imply new rules for the respective bank, but also that new supervisors would more or less have to start from the scratch to get a picture of it.

In addition, a two-tier structure would probably require a dual regime as regards crisis management, deposit insurance, etc. Would this not significantly complicate the supervisory framework?

Finally, as also mentioned in the paper, it is likely that the information advantages based on the current proximity of supervisors and supervised institutions would be lost, again with potential implications for financial stability.

I think that it could be very interesting to further deepen the discussion on these issues. It might also be worth noting that the German government recently issued a paper[1], in which a similar approach has been suggested: A European system of financial supervision should be created, with supervision of providers of financial services who operate solely at national level remaining with the national authorities.

3.2.2 Transitional Arrangements

Concerning the suggested transition arrangements in the paper, a preference is expressed for an evolutionary or gradualist approach: The current coordinating bodies, I suppose reference is made here to the level 3 committees, should be the nucleus of a future supervisory agency, gradually assuming more responsibilities,

[1] Growth and Employment for the Years through 2010. Position of the German Government on the Mid-term Review of the Lisbon Strategy (October 2004).

with a full functional transfer and the creation of an institutionalised EU supervisory agency coming at the end of a potentially quite extensive transition phase. Further, it is proposed that an evolutionary approach would also be appropriate regarding the sectoral unification of supervision.

In a consultation paper[2] issued at the end of October 2004, CESR – the Committee of European Securities Regulators – similarly considered that the legal profile of CESR could be upgraded in order to allow single EU decisions. However, it was noted that all available tools under the current framework should be explored before envisaging more far reaching approaches and that so far there is no need for such an upgrading. Moreover, in the CESR paper it was also explained that issues related to the prudential supervision of banks or insurance companies are not covered, given that they are of fundamental different nature and focus.

Personally, I think, and now I refer again to the banking sector, that some kind of mixed responsibilities, which are inherent to the described evolutionary approach, bear the potential of substantial problems: How can the respective competences and responsibilities be clearly assigned to one authority or the other? What about liability? What about crisis management? etc.

These problems become even more obvious in the context of the so-called lead supervisor approach, which is favoured by some large European banking groups and which is also often seen as interim solution on the way to the final objective of a European Supervisory Authority. According to this approach, the supervisor of the parent institution should be assigned substantial – if not all – supervisory competences in relation to the subsidiaries. However, this would also imply the described legal problems, could distort the level playing field and would in several cases lead to the result that one jurisdiction is responsible for supervision while another one would have to pay in case of a crisis.

Against this background, and in order to avoid these problems, I am more of the opinion that a clear move to a new system would be preferable, provided that the essential preconditions are fulfilled. However, I fully agree that for the time being, any quick move to a new system would be clearly premature and at this stage not appropriate: the single market is not yet sufficiently integrated, the current co-operation system has a strong track record and has only recently been reformed and, finally, the regulatory framework is currently subject to substantial changes due to Basel II, Solvency II, etc.

3.2.3 Alternative Approach

From my personal opinion, any shift to a more centralised supervisory approach would have to comply with the following criteria:

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[2] Preliminary Progress Report: Which Supervisory Tools for the EU Securities Markets? An analytical paper by CESR (Ref: 04-333f/October 2004).

Firstly, I consider it as important that any concepts provide for clear structures and responsibilities, in the transitional period as well as in the final stage.

Secondly, as I have just mentioned, I do not think that the current supervisory system should be changed for the time being: In particular, since the financial market is not yet fully integrated and national specificities have to be taken into account, not least from a financial stability point of view. It should be considered what the consequences of a unification of supervisory regulation would be, and whether a more centralised structure could create risks for the individual credit institution, for example due to a shift of the focus of supervisors to a more group-wide perspective?

Further, I would like to add that the new Lamfalussy-committees have only recently been established in order to address exactly the identified regulatory/supervisory challenges, and they should now be given the possibility to work. For example, in the paper it is noted that Basel II contains a high number of discretions, and that these discretions carry the possibility that standards will be differently applied across Member States. In the last months, CEBS – the Committee of European Banking Supervisors – has worked on this issue and put forward a proposal for deletion of some of these discretions to the Dutch Presidency and the Commission; further, CEBS will try to enhance convergence in the exercise of the remaining supervisory discretions. Another example mentioned in the paper is reporting: Here, CEBS will soon start a consultation process to achieve a common solvency ratio reporting framework under the Basel II framework. Moreover, as regards the issue of information exchange, CEBS' mandate explicitly states that CEBS has to promote supervisory co-operation, including through the exchange of information; finally, concerning cross-sectoral issues, the three level 3 committees have already established arrangements for close co-operation.

It is also important to keep in mind that work on consistent implementation of community legislation and supervisory convergence, which is the core mandate of CEBS, is in any case a precondition for further centralisation, irrespective of any final solution. At the same time, the current system would have the advantage that it still allows taking into account national specificities where required. Finally, if the system works appropriately, I see no urgent need for any changes. In the paper, it was also clearly expressed that the ability of these present arrangements to cope with the current challenges will influence the debate on the need and timing for institutional reform.

Some kind of European Supervisory Authority seems – from my perspective – in principle possible, but – and this is important – only in a long term perspective and only, if a number of preconditions are met:

There has to be enhanced financial market and political integration.

A number of accompanying measures have to be taken, e.g. as regards accountability arrangements, crisis management, changes in national administrative laws, etc.

In order to ensure that supervisors receive all the required information, only a decentralised organisation seems possible.

A European Supervisory Authority should be competent for the supervision of all institutions, irrespective of whether they carry out cross-border activities or not.

As regards the scope of such an authority, I personally think that it would – at least in a first step – have to be created on a sectoral basis (European Banking Supervisory Authority).

4. Crisis Management

At this point I turn very briefly to the issue of crisis management: The Memorandum of Understanding between central banks and banking supervisors on crisis management, which is a very valuable tool in this respect, has already been mentioned. It also seems to be worth mentioning that the European Commission's proposal for a capital requirements directive (*Basel II*) contains in addition a provision that aims at ensuring appropriate information not only of (non-supervisory) central banks, but also of finance ministries.

In particular, the paper addressed deposit insurance and lender of last resort issues: Based on an EC directive, deposit insurance is organised on national level, in principle on basis of the home-country principle, with the possibility for branches to top up in the host country. This implies, as pointed out in the paper, some questions in the case of a major restructuring of subsidiaries into branches. Depending on future developments it could also be necessary to address the fact that deposit insurance schemes are still quite different within the EU.

The relevant European institutions and fora are aware of these issues, and also of questions related to the lender of last resort function (in a wider sense). As regards the latter, basically three issues have to be addressed: first, the arrangements for emergency liquidity assistance provided by central banks in exceptional cases and second, the use of tax-payers' money, or more generally the conditions under which a Member State provides financial aid. These arrangements have to be a bit *ambiguous* in order to avoid moral hazard effects; third, the interplay between supervisory authorities, central banks and finance ministries, which has to be flexible in order to appropriately address and cover the different potential crisis situations.

5. Conclusions

The objective of the presented paper is to contribute to the search for a consensus. From my point of view, this objective has been met without doubt, even though it is clear that the raised issues will require further consideration over the next years.

Fiscal Policy and Democracy in Europe

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1. Introduction

By adopting the euro as its single currency, the European Union has made significant progress in the efficient management of macroeconomic policy. The single market is less vulnerable to financial, economic and political shocks and even non-euro countries in the Union profit from this fact. However, it has also become apparent that the mix of monetary and fiscal policies has not always been optimal. Domestic demand in Euroland has mostly been feeble, especially when compared to the UK and USA, and fiscal policy has been too lax during the boom year 2000 (European Commission, 2003). This policy weakness has institutional foundations. The integration of national fiscal policies into a coherent European stance is the main problem, as the difficulties of implementing the Stability and Growth Pact reveal. But in addition, the determination of the EU budget in the context of the new financial framework 2007–2013 risks undermining the functionability of the EU. In this paper, I will argue that an optimal policy mix in Euroland requires an integrated fiscal policy framework that also takes into account the budget of the EU.

2. The EU's Budgetary Constitution

European Monetary Union has created a unique institutional arrangement for the conduct of European macroeconomic policy: monetary policy is centralised under the authority of the ECB and conducted in a unified and coherent manner. But fiscal policy remains fragmented, with national governments keeping their budgetary authority. They are only loosely constrained by the Excessive Deficit

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Procedure (EDP) and the related application directives, the Stability and Growth Pact (SGP).

This set-up is somewhat surprising, given that the theory of Fiscal Federalism since Musgrave (1959) has emphasised the welfare gains from centralising the public finance functions of stabilisation and redistribution and decentralising the allocation function. Earlier EU-documents, like the MacDougall Report (1979) and the Delors Report (1989)[2] gave a prominent role to fiscal policy: "Both for the purpose of internal macroeconomic objectives and in order to be able to participate in the process of international policy coordination, the Community will require a framework for determining a coherent mix of monetary and fiscal policies" (Delors Report, 1989, p. 94). When the Maastricht Treaty was negotiated, governments were only willing to give up monetary policy, but they kept budgetary sovereignty for themselves. They did this for ideological and political reasons.

Politicians follow the ideas of their time. By the early 1990s, stabilisation policy had been reduced to only maintaining price stability. Employment and output stabilisation were ignored. Fiscal policy at the European level was to prevent the "undue appropriation of EMU savings by one country" (Delors Report, 1989, p. 95) and the crowding out of private savings through excessive deficits. At the theoretical level, the Ricardian Equivalence hypothesis (Barro, 1974) had undermined the Keynesian assumption that government net expenditure could compensate shortfalls in private sector demand. Budget policies were now considered ineffective with respect to "real" economic variables, but they could cause inflation in the long run. Fiscal discipline was seen as necessary to ensure financial stability, but institutions actively pursuing macroeconomic stability were not deemed necessary. Yet, if consumers do not internalise the future tax implication of current deficits ("future generations will pay for them"), Ricardian equivalence fails. After a long debate, it has again been acknowledged in recent years, that fiscal policy can smooth the business cycle by the operation of automatic stabilisers (changes in government revenue and expenditure that arise automatically from fluctuations in economic activity). The new orthodoxy also emphasises the usefulness of discretionary fiscal policies for supply-side effects, such as improving the potential growth rate, covering pension liabilities, creating labour market flexibility, etc. However, discretion for the purpose of demand management is to be avoided (ECB, 2004). Demand is best served by automatic stabilisers, which introduce some flexibility into rule-based policies. These automatic stabilisers therefore contribute to the efficiency of macroeconomic policy, while discretionary supply policies reflect more fundamental choices of collective policy preferences.

[2] In the paper contained in the Delors Report (1989), Lamfalussy explicitly referred to Musgrave.

The other reason for the EMU's institutional arrangement was political. Initially, more audacious government delegations (especially the French) recognised during the Maastricht negotiation that the loss of national sovereignty on the budget side could lead to a larger EU budget and this would not be politically acceptable (Bini-Smaghi, Padoa-Schioppa, and Papadia, 1994). For example, central government expenditure varies in Australia, USA, Switzerland and Germany between 8% and 14% of GDP, and if social security is included between 18% and 31% , while state and local government only spend between 10% and 14% (Ardy, 2004). Such proportions are considered as unacceptable for the European Union.

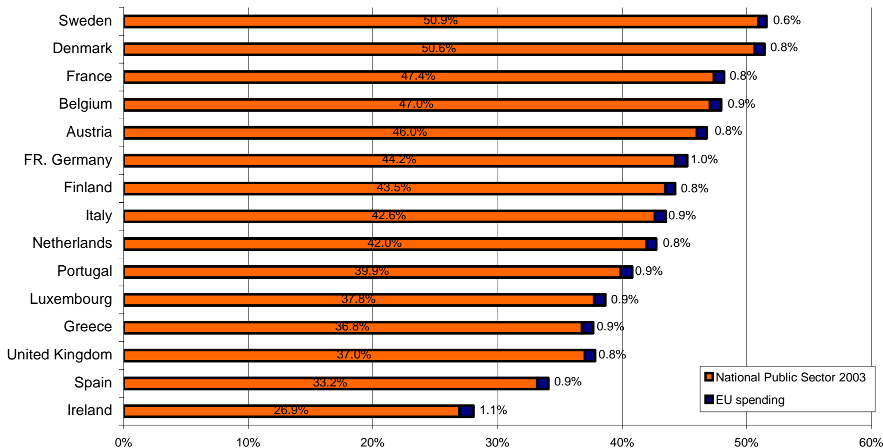
Yet, there is a dilemma according to the theory of fiscal federalism. An efficient European budget needs to be small from the point of view of allocative efficiency, but large for stabilisation purposes. The efficient allocation of resources requires that the optimal level of public goods (i.e. that for which the sum of resident's marginal benefits equals marginal cost) reflects the differences in local preferences and costs; because preference heterogeneity is assumed to increase with the number of citizens, decentralisation is supposed to increase welfare and a big EU budget is undesirable.[3] Yet, if government expenditure is to make a difference in terms of smoothing aggregate demand and income, it must be substantial. This condition is generally fulfilled for national budget policies, but not for the EU budget. For example, total government expenditure in the USA was 31.9% in 2003, 33.9% in Japan and 44.5% for the euro area, while the total EU budget represents only 1% of GDP. As Lamfalussy put it in the Delors Report (1989, p. 95): "The size of the Community budget would clearly be too small to provide for an adequate *masse de manoeuvre* for an effective macro-fiscal policy. As a result, in an EMU an appropriate aggregate fiscal policy could not be determined without impinging on the autonomy of national budgetary positions". Given that most of public spending in the EU is undertaken by member state governments (see chart 1)[4], the stabilisation function in Euroland must work through national budgets. The

[3] As Oates (2004, pp. 26–7) points out, "decentralised levels of government focus their efforts on providing public goods whose consumption is limited primarily to their own constituencies. In this way, they can adopt outputs of such services to the particular tastes, costs, and other circumstances that characterise their own jurisdictions." Thus, in this decentralising theory of fiscal federalism, which Europeans call subsidiarity, there is no place for spillover effects of public goods into other constituencies. In Collignon (2003) I have argued that this model is not suitable for policy analysis in the European Union, where spillover effects are widespread. Many collective goods are consumed by all European citizens, although they do not have the institutions to match policy output with the democratic policy input.

[4] All data used in charts and table in this paper are taken from the AMECO data base of the European Commission DG ECFIN unless indicated otherwise.

aggregate fiscal policy stance in Euroland, which matters for monetary policy, is then the book-keeping result of adding up the different national budget positions.

Chart 1: Total Public Spending as Percent of GDP



According to the orthodox interpretation, this arrangement does not prevent an efficient policy mix (Artis and Buti, 2000). If member states kept their cyclically adjusted budgets in balance, as postulated by the Stability and Growth Pact, the swing of automatic stabilisers would provide for the efficient counter-cyclical stabilisation of demand shocks. All one needs to do, therefore, is to provide safeguards against opportunistic behaviour by keeping individual member states to some simple rule.

However, this model has come under criticism from two sides. Most has focused on the system's rigidity, which prevents the proper functioning of the automatic stabilisers and inhibits efficient macroeconomic stabilisation. But an additional and much less discussed question is its optimality with respect to satisfying collective preferences.

3. The Macroeconomic Stabilisation Function

Fiscal federalism refers to the development of a centralised budgetary system[5] comprising all members of a federation or federal state and how to assign different

[5] This is the half-empty bottle. Of course the same statement can be made in terms of decentralising competencies.

functions of public finance to different jurisdictions (Baimbridge and Whyman, 2004). The classical theory of fiscal federalism has established three major arguments why a monetary union needs to have a centralized budget policy: stabilising symmetric and asymmetric shocks and income redistribution. By contrast, the allocation function may be better served by decentralisation.

3.1 Symmetric Shocks

First, there is the argument of *vertical flexibility* in budget policy. Vertical flexibility is about the appropriate response of an economy to a symmetric shock that hits all regions of the federation in a similar fashion. In principle, monetary policy could respond to such a shock by lowering interest rates, thereby stimulating demand. Similarly, a supply shock, such as an oil price increase, would require a unified response in order to avoid beggar-your-neighbourhood behaviour through the distortion of relative prices. It is usually argued that a centralised budget is better able to internalise externalities associated with both taxation and expenditure. Regional governments may not undertake an optimal level of counter-cyclical stabilisation because of the existence of regional spillovers. Non-residents may derive some benefits from an expansionary policy, whilst residents must bear the full cost through higher debt or taxation. This may prevent an efficient policy response. In order to avoid this prisoner's dilemma, coordination of stabilisation policies amongst all members of the monetary union would be required unless a sufficiently large centralised government under federal authority is available. The European approach consisted in coordinating fiscal policies through the Stability and Growth Pact. The Pact stipulates that each member state should keep its budget "in balance or surplus over the medium term". This must mean that governments keep their cyclically adjusted budgets in balance, so that the automatic stabilisers can smoothen the business cycle.

Despite their formal commitments, governments have not exactly followed this model. As chart 2 shows, the structural deficit of the euro area as a whole has improved in the run-up to EMU, but it has remained stable at a level close to 2% since then. It is therefore far from being balanced. The automatic stabilisers did operate in the 2000-boom but the subsequent deterioration of the cyclically adjusted deficit, due to tax cuts in several member states (notably Germany and France), indicates moderate procyclical behaviour in the EU's fiscal behaviour. In 2003, the aggregate Euroland fiscal position came close to the 3 percent line, while several individual member states surpassed it. This is worrisome, for if the euro area were hit by a severe shock (say a further increase in oil prices), the Stability and Growth Pact would restrain the automatic stabilisers and fiscal policy would become pro-cyclically restrictive.

Chart 2: Euro Area Aggregate Fiscal Stance

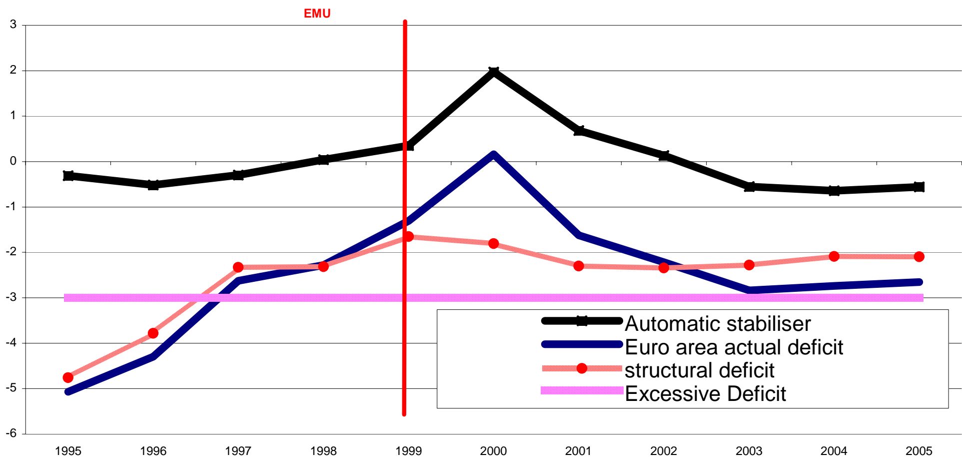
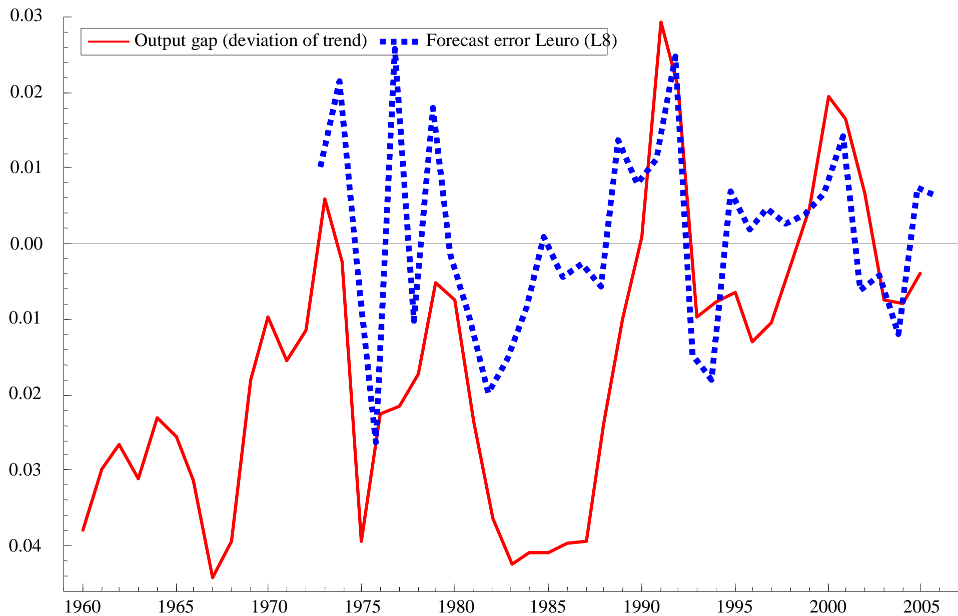


Chart 3: Euro Area Output Gaps and Economic Shocks



Furthermore, economic shocks have recently been less strong than in previous periods. As chart 3 shows, the output gap, as measured by the European Commission[6] has been mainly negative before EMU started. However, given the methodological difficulties in measuring output gaps, I have calculated economic shocks as the forecast error of an AR (8) process for the log of annual Euroland GDP. The volatility of economic shocks has clearly fallen since the mid 1990s. This may be a consequence of monetary integration, or of a favourable environment, but there is no guarantee that it will stay that way. If volatility increases again, more vertical flexibility would be needed in budget policies.

3.2 Asymmetric Shocks

Second, *horizontal flexibility* in budgetary policy is required when a federation is hit by asymmetric shocks. In this case monetary policy is not available to stimulate local demand, given its unified tools. Regional budgets could provide additional demand and discriminatory fiscal policies could provide distorting supply side effects. Hence, some form of horizontal policy coordination is desirable.

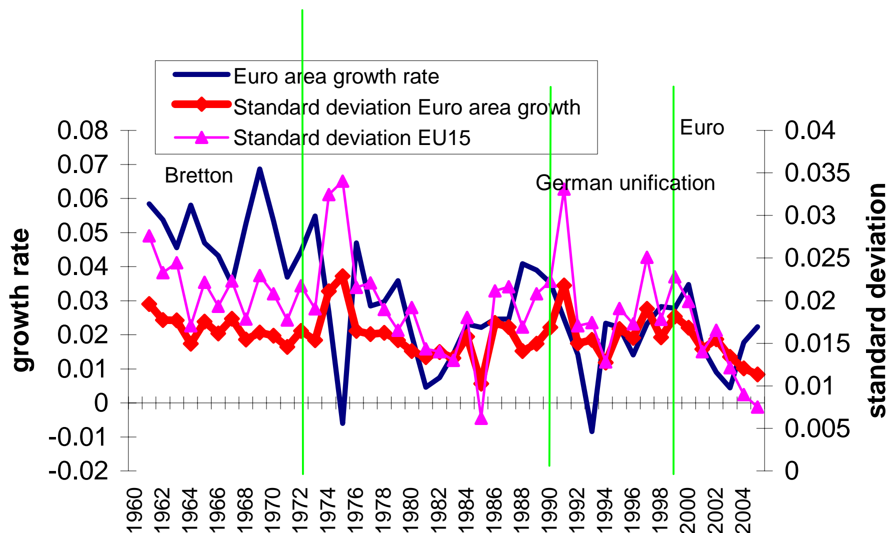
The salience of horizontal flexibility depends on the likelihood and the extent of regional asymmetric shocks. The discussion of such shocks has been the delight of economists in the context of Optimal Currency Area theory. But since the start of EMU many economists have learned to accept that the occurrence of asymmetric shocks may be related to the degree of economic and monetary integration (Ackrill, 2004; Collignon, 2001). Chart 4 indicates that the movements of national GDP growth rates have become more uniform since monetary union started: the standard deviation of annual national growth rates within the EU and the euro area have been falling. This is all the more interesting, as in previous year a major growth reduction was usually associated with an increase in growth volatility across the area.

How is horizontal flexibility to be achieved? Fatás (1998) has distinguished between *intertemporal* and *interregional* transfers, by which a federal fiscal system can compensate asymmetric macroeconomic shocks. Intertemporal transfers result from government borrowing to stabilise consumers' income in case of an adverse regional shock. Interregional transfers play an insurance role in the case of asymmetric shocks and take place through a federal budget mechanism that transfers income from surplus to deficit areas. While the intertemporal argument follows the traditional Keynesian stabilisation theory, it implies significant externalities and requires policy solutions in a monetary union that are different from unitary nation states. For if the central bank keeps money tight to ensure the economy's hard budget constraint, the extra borrowing of one region would push

[6] Calculated as the deviation from trend output based on a production function.

interest rates up for the whole economy.[7] One reason for the SGP was the intention to prevent individual member states from free-riding on intertemporal transfers, at the expense and detriment of others. However, this disciplining device comes at the cost of less than optimal stabilisation in a country hit by an asymmetric shock. For if there is no interregional transfer mechanism, all the adjustment would have to be made by intertemporal transfers region by region, and if the amount of borrowing exceeds the permissible norm of the SGP, stabilisation is impeded. This negative result could not be avoided if asymmetric shocks were normally distributed because there would be no need to constrain deficits. Additional borrowing by one region would be funded by unexpected government savings in another region. On average, the capital market would remain in balance and interest rates would not be affected. The overall hard monetary budget constraint would be binding and price stability would be maintained (ceteris paribus). However, given the very unequal distribution in member state size, it is unlikely that asymmetric shocks in Euroland have a zero mean. Therefore, intertemporal transfers interact with aggregate macroeconomic stability and they cannot substitute for interregional transfers.

Chart 4: Asymmetry of Shocks in the Euro Area



[7] This is an argument about the short-term interest rate in the money market, which is controlled by monetary authorities. If the long-term interest rate in the capital market were fixed by the international supply and demand for capital, the yield curve would be negatively affected by regional borrowing.

Federal systems often seek to overcome these difficulties by establishing a system of interregional transfers, which provide insurance against asymmetric shocks by pooling the risks of national income fluctuations at a higher level of aggregation (Schelkle, 2002). An interregional public insurance scheme redistributes income from favourably shocked to adversely shocked regions, while maintaining the overall stability of the aggregate fiscal policy stance required for maintaining price stability.[8] In mature federal states, like the United States of America in the 20th century, these horizontal transfers are affected through the federal budget. In Germany, the *Länderfinanzausgleich* (interregional transfers) also requires the federal budget to balance inconsistent regional claims. In the European Union this is more complicated. Regional stabilisation does not work through an insurance scheme, but essentially through intertemporal transfers when national budget deficits respond to asymmetric shocks through the mechanism of automatic stabilizers. But as argued above, this is not optimal. The European budget is small (less than 1.2% of GDP) and its two main spending categories, agriculture and regional policy, reflect redistribution objectives, not stabilisation. Interregional transfers do not reflect economic shocks but more fundamental preferences for income redistribution.

3.3 The Redistribution Function

The redistribution function of the EU budget relates to our third argument in favour of centralising budget policy in federations. After passing the Single European Act, it soon became clear that continued political support for the Union required solidaristic transfer schemes to help economically weaker regions. In principle, these transfers could either be financed through intergovernmental grants, or through progressive taxation as in many nation-states. In the EU, intergovernmental grants are not financed by a transfer from a federal budget to lower level jurisdictions, but by transfers from national budgets to the EU budget. In fact, 80% of the European budget spending consists of transfers, half of them through the common agricultural policy, the other half for regional policy. This spending is financed by the so-called *own resources* of the European Union that have, however, little to do with own resources (the only exception is a small amount of income from customs duties). The funding of the European budget is actually a levy on national government's budgets that automatically balances the EU budget by claiming transfers in proportion to GDP (Brehon, 2004).

This system has far reaching consequences for the legitimacy, acceptance and sustainability of European budget decisions. When transfers are channelled through a federal budget, the budget decisions reflect aggregate citizen's preferences as

[8] The welfare gain from such insurance device declines, of course, as the likelihood of idiosyncratic shocks diminishes. See chart 4 and Ackrill (2004).

they have emerged from the electoral process at the federal level. These choices may conflict with partial interests of regionally regrouped voters, but there is a legitimate debate between the two levels that, in principle, articulates the interests of all citizens concerned. This is not so in the European case. The aggregate interests of European citizens cannot be articulated, because budget decisions are the exclusive domain of national governments.[9] Only the partial interest of national representation in the Council is possible. As a consequence, decision options that would maximise the aggregate utility of all European citizens carry less weight than the bargained Nash equilibria which are the result of intergovernmental bargaining in the Council. This is of particular relevance for distributional issues.

The budget of the European Union is a redistribution budget. 80% of expenditure is concentrated on the common agriculture policy and structural or cohesion funds. The former aims at stabilising income of a specific group of the population; the latter provides matching grants to accelerate regional development. Given, that the European Union budget is not allowed to borrow in capital markets, all resources are effectively transfers from national treasuries. National governments contribute to the European Union budget roughly by size of their country's GDP and they receive funds back from the European Union in accordance with the criteria and tasks established for dispersement. Thus, countries with high concentration of agriculture or of poor regions receive more funds in return, than countries who have more balanced structures or are wealthier. In recent years, 4 countries, out of 15 EU countries, have been net-transfer recipients, 10 were net contributors, and in Finland inflows and out flows were balanced. European net-contributions must therefore be seen as one expenditure item amongst many others in national European budgets. Yet, given that the overall fiscal policy framework requires national government budgets to be balanced over the business cycle and that governments have to avoid excessive deficits, the amount of net contributions distorts fiscal discipline and undermines European stability. For if a national government needs to consolidate its budget, a net transfer of funds to European citizens who are not voters in the government's constituency is not easily justifiable. This explains partly why discussions of the net contribution to the European budget are so highly charged by EU Member States.

The EU budget system, linked to the fiscal discipline devices of the SGP, creates an awkward dilemma: the more generous a member state behaves in transferring resources to poorer countries, the higher the likelihood that it will be punished under the Excessive Deficit Procedure, if it is hit by a shock. Each Member State therefore has an incentive to reduce its contribution to the EU

[9] The Convention preparing the draft European constitution gave increased budgetary power to the European Parliament, but in the subsequent Intergovernmental Conference national governments withdrew these arrangements and preserved their exclusive authority.

budget in order to comply with the SGP. This arrangement increases the risk of European disintegration, particularly at a moment when the accession of ten new low income countries creates additional claims for resource transfers.

Table 1 gives an idea of the magnitudes in 2002. Net budget transfers into Greece and Portugal exceeded 2% of GDP; in Spain and Ireland they were close to 1¼ percent. However, the effective tax burden on citizens in the Netherlands are nearly ½ percent of GDP and a quarter in Sweden, Germany and Italy. Only Finland is in balance. In 6 out of 14 countries (data for Luxemburg were not available) the net contribution to the EU budget is higher than the magnitude of the automatic stabilisers in 2002. As a consequence of the net transfers, Portugal remained below the 3% deficit level of the EDP, and France was pushed beyond the limit. If the Netherlands would wish to balance their structural deficit, as required under the SGP, their consolidation efforts have to be 24% higher than if their net contribution were balanced. For Italy the extra effort is nearly 10%, for Germany 7% and for France 4%.

Table 1: European Net Contributions and Budget Deficits 2002

In % of GDP	Net contribution NC	Cycle deficit	Structural deficit SD	SD-NC	Actual deficit AD	AD-NC
Portugal	2.08	0.02	**-2.72**	**-4.81**	-2.71	***-4.79***
FR. Germany	-0.24	-0.15	**-3.37**	**-3.13**	***-3.52***	***-3.28***
France	-0.14	0.56	**-3.66**	**-3.52**	***-3.10***	-2.96
Greece	2.40	1.31	**-1.46**	**-3.86**	-0.16	-2.55
Italy	-0.23	-0.01	**-2.30**	**-2.07**	-2.31	-2.08
Austria	-0.10	-1.43	-0.15	-0.04	-1.58	-1.47
Belgium	-0.10	-1.54	0.02	0.12	-1.52	-1.43
Spain	1.27	-0.12	0.21	-1.07	0.09	-1.18
United Kingdom	-0.17	1.18	**-1.41**	**-1.24**	-0.24	-0.06
Ireland	1.22	3.16	**-1.87**	**-3.09**	1.29	0.07
Netherlands	-0.49	2.11	**-2.05**	**-1.56**	0.05	0.54
Sweden	-0.29	1.06	0.81	1.10	1.87	2.16
Denmark	-0.09	1.33	1.11	1.20	2.44	2.53
Finland	0.00	0.44	3.75	3.76	4.20	4.20

Source: European Commission.

Because the four cohesion countries receive a net contribution from the rest of the Union, their excess of expenditure over national tax income can go above 4% of GDP. On the other hand, net-contributors to the European budget are severely restrained in their borrowing capacity. In particular Germany, which has arguably the need for a significant amount of borrowing in order to finance the restructuring of public infrastructure in Eastern Germany, the limit on the borrowing capacity for

national purposes is not 3%, but 2.74%. Thus, we may conclude that the burden of fiscal discipline on national budget policies is not equitably distributed and does not provide a regional insurance scheme for asymmetric shocks. These two failings are a double threat for the legitimacy and sustainability of European integration. How could they be remedied?

4. Integrating European and National Budget Policies

An efficient European budget arrangement should provide vertical flexibility in order to deal with macroeconomic shocks affecting the whole euro area, and horizontal flexibility that allows the stabilisation of asymmetric shocks in specific countries. In addition, it should have a mechanism whereby the European budget reflects the preferences of European citizens for the public goods they share, including their views on stabilisation, redistribution and solidarity. I will now suggest an institutional arrangement, capable of integrating those three requirements. It will also increase the efficiency of fiscal policy by strengthening its democratic legitimacy.

4.1 Defining the Aggregate Fiscal Policy Stance: Vertical Flexibility

What matters for macroeconomic stabilisation in a single currency area is the mix, or rather the interaction, between monetary and fiscal policy. But because monetary policy is fully unified, fiscal policy also requires a coherent, unified aggregate stance. Given, that the bulk of expenditure in the EU is allocated by national governments, a mechanism is needed to define the desired aggregate fiscal position (total public expenditure minus revenue). This aggregate fiscal policy stance should reflect the economic conditions of the whole of European Monetary Union, but also collective preferences for the allocation of resources, including their distribution between national and European public goods. However, once the aggregate deficit is defined at the European level – which is where it belongs to fulfil the stabilisation function and implementation could take place at the level of the appropriate jurisdictions – each jurisdiction must be assigned a share of this total deficit for implementation. Within their quota national governments would then set the priorities for collective goods that reflect their voters' preferences. For example, one country may have a preference for a large public sector and therefore higher taxes, while another may opt for small government and low taxes, but both must stick to the authorised net borrowing requirements. This idea addresses the earlier mentioned dilemma, whereby the stabilisation function of public finances needs to be efficiently dealt with at the central level, while the allocation function can respond flexibly to preference heterogeneity.

Technically the procedure of first defining the macroeconomic aggregate and then its micro application in a second step is not unusual. For example, the French parliament votes first a macroeconomic framework law, so that the subsequent detailed item voting within the overall budget constraint (*les arbitrages*) ensures that specific preferences remain coherent with the overall stability requirement.[10] Similarly, the budget process in Italy defines first the multi-annual macroeconomic framework law, the Programmazione Economico e Finanziario (*DPEF)*, and then the *legge finanziaria*, which implements the actual budget allocations (Amato, 2000). In the European context, there exists an instrument that could be developed to serve an efficient budget process. One could redefine the Broad Economic Policy Guidelines (BEPG) to take the function of a binding annual macroeconomic framework law. These guidelines would set the authorised *aggregate* spending and income targets for all EU public authorities (from municipalities to regions, nations and the EU budget), as they seem relevant from a business cycle point of view, but also with respect to intergenerational burden sharing. As such the BEPG would effectively define the aggregate budget deficit of the European Union for any given year. This would ensure vertical flexibility of Europe's fiscal policy. The transformation of the BEPG into a macroeconomic framework law does not prevent them from continuing their function of giving orientation and direction to Member States for the European economy's supply-side reforms.

However in order to make these revamped BEPGs a binding legal commitment that entitles the European Union to superimpose budget rules on national parliaments, it is essential that they have full democratic legitimacy. It is obvious that an un-elected Fiscal Policy Committee of "experts", as suggested by Wyplosz (2002), is totally incompatible with fundamental democratic norms.[11] But political legitimacy cannot simply be derived from the legitimacy of national governments represented in the Council. In a representative democracy citizens are the principals who charge governments as their agent with the task of implementing their collective preferences, or at least those of the majority. If the agent does not perform, or if the preferences change, the principal must have the right to remove

[10] In fact this arrangement was one of the essential innovations of the Fifth Republic on the fiscal policy side.

[11] Wyplosz (2002) argues "budget deficits have a limited intra-temporal reallocation effect. They mostly redistribute income across generations, most of which are not yet in existence and play not part in democratic control. Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit." Such an approach does not understand that democracy is about more than the technocratic efficiency or policy output. It is also about policy input legitimacy. The deliberative aspect of democratic collective choice is what distinguishes a dictatorship, even an enlightened and benevolent one, from a regime where citizens are free and equal. See Elster (1998).

and appoint another government. Otherwise the agent loses legitimacy. It is an important feature of democracies, partly caused by the information asymmetry between principal and agent,[12] that this verification takes place at periodic intervals through elections, in which each citizen has an equal share in the decision-making. The periodicity is necessary for the protection of human rights and to ensure the efficiency of government action, which must not be disrupted by frequent stochastic shocks in public opinion (Elster, 1993). But also, most importantly, electoral campaigns play an important role in the formation of collective preferences by correcting the asymmetric information problem between principal and agent.

The exchange of ideas, views and opinions between citizens who listen to each other and express their individual policy preferences prior to elections accelerates the emergence of a policy consensus around the median voter (Collignon, 2003). Without the focal point of periodically reoccurring elections, preference heterogeneity is likely to persist. This is the reason for the persistence of heterogeneity in European preferences. Thus, contrary to the theory of fiscal federalism, we must not assume collective preferences as exogenously given, but consider their change and evolution as a result of the institutional processes of collective deliberation. This also explains why the democratic deficit in Europe cannot be closed by the European Council. For although one may argue that national citizens are represented by their governments in the Council, there is no mechanism by which the European principal can revoke the agent (i.e. the European decision-maker namely the Council), if it does not perform, because there is no election for a European government. Governance without government, which is the intergovernmental method, implies there is no agent that can be made accountable and revocable. The European Commission is the agent of governments, the derived agent of the agents.[13] Consequently there is also no European-wide deliberative process that would help to overcome preference heterogeneity. The Council is in fact an eternal parliament that is continuously renewed by by-elections. Such a system can hardly be called a democracy and it should surprise nobody that a European Union run by intergovernmentalism will ultimately lose the trust of its citizens and cease to be effective. The conclusion is simple: for the whole range of public goods, which affect each European citizen,

[12] The asymmetric information problem in principal-agent relationships arises from the fact that the agent can use information from running the business for his own use, while the principal may not have access to such information. Quite obviously this is the case in all representative democracies.

[13] The rejection of the Barroso Commission by the European Parliament shows the dilemma: the president and the commissioners are nominated by the Council and do not necessarily reflect the views and majorities that emerged from the Parliament' elections. However, the fact that the EP has to consent is an important step towards a European democracy.

there has to be a democratic process to establish their collective preferences. Each citizen must have the right to cast a vote, and to participate in the deliberations about collective European choices. They must be able to express, discuss and control their collective choices; the appropriate instrument for this is the European Parliament.

It follows that, if the EU would aim to establish the aggregate European budget position as a framework law, the authority for such budget procedure must be with a European institution which is accountable to all citizens, because the consequences of fiscal policy affect every citizen in Euroland. The fiscal policy stance should, therefore, be proposed by the European Commission and then voted by the European Parliament. Subsequently, it would obtain the Council's agreement according to the appropriate legislative procedure. The Council has, of course, a legitimate interest in weighing in on the collective decisions, as European choices may have externalities for local choices. The advantage of this arrangement is not merely procedural. It creates a public domain for the discussion of collective preferences with respect to the fiscal policy choices and the consequences of public borrowing for the level of interest rates. It would therefore would contribute to a better understanding of the policy choices and by strengthening their legitimacy, it would also improve the efficient conduct of European fiscal policy. But even more importantly, by creating a public domain for fiscal policy choices our proposed arrangement would open the door to a proper European democracy. As many authors have pointed out, (Eriksen and Fossum, 2000; Beetham and Lord, 1998; Habermas, 1996), democracy does not require a "demos" with ethnic loyalties and references to a common past, but an agreed political project for a common future. By creating the structures for European policy deliberation involving all citizens concerned, a European identity and with it the European demos will emerge as an unintended consequence.

4.2 Assigning National Deficits: Horizontal Flexibility

Once the aggregate fiscal policy stance has been determined, the respective shares of income, expenditure and deficits have to be allocated to national governments. An obvious benchmark for the allocation of these shares would be the GDP-weight of respective member states. However, this does not take into account asymmetric shocks or heterogeneous preferences for the intergenerational distribution of tax burden. A mechanism is therefore necessary that introduces horizontal flexibility to deal with deviation from the initial allocations without violating the aggregate policy stance.

One method would simply be to leave the authorisation for deviations to negotiations in the Council. No doubt, this solution would delight civil servants in national administrations. But the procedure would be highly intransparent and re-enforce citizens' perceptions of an undemocratic European Union. A more elegant

way could be the introduction of tradable deficit permits (Casella, 1999). Under this procedure each member state would obtain tradable deficit permits reflecting the GDP-weighted proportion of the aggregate deficit defined by the macroeconomic framework law (BEPG).[14] If a country chooses to borrow more, it would have to buy additional deficit permits from countries, which do not wish to use their own quota. Deficit permits therefore ensure interregional transfers, without intertemporal distortions. Hence, the overall budget constraint, which matters for the conduct of monetary policy, is respected.

One advantage of tradable deficit permits is their decentralised applicability. A deficit permit gives the right to borrow and the banking system could be legally prohibited to lend to public authorities that do not have the required deficit permits. Sanctions are therefore self-policing and self-enforcing and no elaborate political process à la Stability Pact is required. Implementation can also be decentralised to lower level jurisdictions (regions, municipalities, etc.) as long as they have borrowing authority. National governments would then have to set a domestic procedure for re-allocating their national quota to lower level authorities. This solves one of the vexed problems of *domestic stability pacts*, which has been a major obstacle for meeting the Maastricht criteria in federalist states, such as in Germany.

Furthermore, by making these permits tradable, the political option of borrowing versus taxing obtains a price that reflects the relevant scarcity of funds. The procedure therefore invites a public debate about citizens' preferences. It thereby contributes to the democratic decision-making in budget policies in the European context and mitigates the tension between aggregate European and partial national interests. Thus, democracy becomes an instrument of European integration.

4.3 Harmonising European Preferences: European Public Goods

The issue of democracy also becomes relevant for the efficient provision of European public goods. As I pointed out above, the arrangement, whereby the EU-budget is a derivative of national budgets, risks disintegrating the Union when under the pressure of partial national interests financial resources are no longer allocated to the required common European tasks. Choosing the quantity and quality of common European goods must be the ultimate responsibility for tax payers, i.e. voting citizens. But what are European public goods?

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[14] More sophisticated solutions could be incorporated. For example, Coeure and Pisani-Ferry (2003) have suggested that, in the interest of the intergenerational smoothing of the tax burden when financing public investment, governments could be allowed to borrow more than 3% of GDP, provided their debt ratio is well below 60%.

The theory of fiscal federalism has emphasised that the allocation function of public finances should be decentralised as far as possible, when collective preferences between communities are heterogeneous. However, apart from the fact that this theory assumes preferences as exogenously given, it largely ignores externalities and spillovers from one jurisdiction to another. For, if policy decisions reflecting the collective preferences in one jurisdiction affect the utility function of citizens in another jurisdiction, then decentralisation will not necessarily be welfare maximising. We may define a European public good as the provision of services, which have the capacity to enter the utility function of each European citizen. Similarly, a national or local public good is defined by affecting only a well-circumcised group of localised citizens. Hence, decisions about the provision of European public goods concern each and every citizen and should therefore be subject to democratic control at the EU-level.

On the other side, the utility of national public goods are not only the outcome of national democratic processes, but they may also be affected by decisions in other jurisdictions. In the later case, cooperation between local/national governments may be sufficient for the internalisation of externalities. But for European public goods this is not enough. Their provision requires democratic legitimacy and control for the same reasons, which were mentioned above in relation to the vertical flexibility of stabilisation policy. In fact, macroeconomic stability is an example for a European public good under our definition. But if the decision about the provision of European public goods is taken at the EU-level by democratic institutions like the European Commission together with the European Parliament, then the funding of these goods also needs to be decided at that level. Hence, the revenue for the EU-budget should be raised by a proper European tax and no longer by a transfer from national budgets.

In order to disentangle national and European budget decisions it is necessary to give full budgetary sovereignty to the European Union institutions for their own budget. This implies that the European Parliament has authority over expenditure of the EU budget and taxing European citizens accordingly.[15] This does not prevent the Council from still having some co-decisional responsibilities, because obviously the provision of EU collective goods and the related taxation would have spillover effects on national utility functions. One could, for example, envisage to set jointly agreed limits to the EU budget’s size, such as keeping the European budget below one, 2% or 3% of GDP – as done today under the Financial Perspectives system. But the crucial point is that the ultimate responsibility for the

[15] The Convention preparing the draft European constitution gave increased budgetary power to the European Parliament, but in the subsequent Intergovernmental Conference, national governments withdrew these arrangements and preserved their exclusive authority. This is another example for the undemocratic character of intergovernmental policy making in Europe.

EU budget is no longer with governments acting as agents for partial interests, but with citizens – hence the principal.

Raising a Euro-tax would disarm the disintegrating tendencies resulting from the above-mentioned fact that the EU budget is an item in the spending plans of national treasuries. It would remove the unequal fiscal constraint imposed by the SGP on net contributors to the EU-budget. Every national government would have exactly the same borrowing capacity of say 3% of GDP – or whatever else is agreed under the macroeconomic policy framework. Additional projects in net recipient countries would be funded by the Euro-tax affecting every citizen in an equitable manner and eliminating today's nationalist biases in the funding for European public goods. This does not imply a higher tax burden for citizens, as the national government's revenue should be reduced pro rata. Instead every citizen would have to evaluate prior to EP-elections whether his/her tax money is spend for the European public goods he or she desires and which political parties reflect their preferences best. The existence of a democratic process to determine this at periodic intervals is also necessary for the gradual convergence in policy preferences in Europe. It has the advantage that the disintegrative budget haggling between national governments that occurs every seven years when deciding the Financial Perspectives would cease, and a clear assignment of responsibilities for public expenditure would be assigned to the different levels of the European Union.

Several technical questions need to be clarified. First, what should be the appropriate tax base for such a euro tax? The obvious candidates are transactions in the European Single market. It could be limited to goods and services or to factors of production. In the first case, the euro tax could become a small basic portion of VAT, that is substituted for the national revenue. In the second case, it should be based on mobile factors of production, essentially corporate or capital income. This latter approach has the advantage of removing tax distortions in the single market that are caused by the desire of national governments to retain domestic investment and to attract FDI.

Second, once the tax base is decided, the tax rate depends on the amount of revenue, which needs to be raised. Today's EU budget amounts to approximately EUR 100 billion or approximately 1% of GDP. In 2004, total indirect taxes amounted to EUR 1,310 billion , and in 2002 total corporate gross income was EUR 1,377 billion[16]. Thus, a refinancing of the existing budget would amount to a small portion of VAT, certainly not more than 2 percentage points, and a reasonable corporate tax rate.

[16] Data from European Commission, AMECO data base.

5. Conclusion

With the creation of EMU, the role of national financial policy has changed and a more coherent approach to macro-economic policy is required to improve efficiency. But at today's level of integration, policy efficiency requires democratic legitimacy, the interaction between the Stability and Growth Pact and the European budget have the potential to disrupt the Union's capacity to provide itself with the public goods it requires. In the context of the SGP, additional claims on the EU's public finances, resulting from enlargement, will increase the dangers of political conflict and disintegration

What is required is a coherent fiscal policy that has democratic legitimacy and delivers the economic growth necessary to accommodate the expectations of Europe's citizens. Inventing new ways for Europe's fiscal policy may be a rewarding enterprise.

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Comment on Stefan Collignon: "Fiscal Policy and Democracy in Europe"

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Before starting, I would like to say that in this presentation I will express my personal views, which do not necessarily represent the official views of the ECB.

Let me begin with a frank approach. Professor Collignon seems to me a European federalist. Living in the UK, he might take this as an insult, but it is not meant as an offence, rather as a compliment. He favours the introduction of a Euro tax to finance the EU budget under the authority and control of the European Parliament. In order to justify his argument he quotes the theory of fiscal federalism and finds that it is advisable to centralize the redistribution and stabilisation functions. However, he is taking federalism as given, which might be taking too much for granted. On this basis he embarks on an analysis over the EU budget to substantiate the proposal for an EU tax, which could lead to efficiency gains in redistribution and stabilisation policies. Professor Collignon concludes that this would contribute to remove the fiscal constraints by the Stability and Growth Pact on net contributions to the EU budget.

I disagree with this line of argumentation. I think the role an EU tax might play in the redistribution and stabilisation policies of the current EU is overestimated.

Let us go, first, to the macroeconomic stabilisation function. He claims that a centralised budget is better able to confront externalities associated both with taxation and expenditure. This is true, but one can also use regulations and specialised agents to internalise these externalities. Currently, we do have specialised agents, in this case the European Commission, and we have a clear regulation to internalise possible externalities in a monetary union associated to for example the free riding incentives of participating member states.

With regards to the redistribution function, he finds that the EU budget is basically a redistribution budget, 40% of the overall expenditure is dedicated to agricultural policy and 40% to cohesion funds, and that these transfers undermine fiscal discipline and European stability. Such a type of redistribution does not provide a regional insurance against asymmetric shocks either, as the funds were not designed with this stabilising purpose in mind. The agricultural expenditures

are an income support scheme for the farmers and the cohesion funds aim at fostering development of the less developed countries. Of course, we can enquire whether these funds are really complying with their function and whether it is good to keep devoting so many resources to theses aims. In fact, from an economic point of view the argument would be that these funds are in general inefficient. To guarantee farmers' income through output subsidies generates distortions. To foster development, the current cohesion funds do not seem to be the most appropriate instrument, because, in the end, they are also an income support fund without any incentives to change the situation of regional underdevelopment.

Following on these arguments, Professor Collignon says that what matters for macro stabilisation is the policy mix and that a single monetary policy requires a unified aggregate fiscal policy stance. He, therefore, argues for a centralized decision on deficit and then proposes to allocate the deficits to the Member States, with tradable permits to allow for deviations from the allocated deficit quota. The mechanism would be that the European Commission proposes the aggregate fiscal policy stance defined by the aggregate deficit, the European Parliament gives its approval and the Council implements the agreement. I have doubts on this proposal. I do not know whether this would be really an improvement in the democratic process with respect to the current situation. Although Member States accept some limitations to their fiscal autonomy in order to prevent externalities, they are not willing to give up their full fiscal sovereignty.

I would say that the current budgetary constitution of the EU reflects the degree of political integration acceptable for Member States. It is a very delicate mechanism, which balances the powers of the Member States to undertake the fiscal policies they see appropriate within a set of rules, which limit negative effects on the other Member States. At the same time it is also a very subtle mechanism in which the Commission is the only specialised agent with the capacity to take the initiative in order to trigger the appropriate procedures that make Member States comply with fiscal discipline. On the other hand the Council is the only institution with the power to take decisions regarding the implementation of these fiscal rules. The Member States find themselves in between the Commission and the Council trying to preserve full fiscal sovereignty without any interferences. All in all it is a relatively delicate system, which can be easily unbalanced if this complicated architecture is biased towards one direction or the other.

There are good arguments to defend a European federal level of government, but these arguments are not founded on stabilisation or redistribution. There are certain public goods like security or defence, which probably would be more efficiently provided at the EU-level than at the state, regional or local level. But there are also other services, for example the enforcement of law etc., which are possibly better provided at a lower level of government. And there are also some merit goods which generate important external economies. A good example would

be higher education and research, which for reasons of external economies and economies of scale might be better provided at an aggregate scale at the European federal level.

If there are some good arguments to spend money at the level of the hypothetical European federal government, probably an efficient way to finance these expenditures, is through taxation. I would agree that taxation of the most mobile factors of production, capital or corporate profits, seems to be an appropriate instrument to finance these federal expenditures.

The draft constitution of the EU clearly reflects the current political realities, but this does not preclude the development of further commitments at the European level in the area of public expenditure and taxation. Therefore, I would like to thank Professor Collignon for this thought provoking paper, which I have enjoyed reading very much.

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