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Legislative and Institutional Dynamics in Response to the Crisis

As an answer to the financial and economic crisis, the European Union decided first steps to improve the regulation and surveillance of financial markets as early as 2009. In the beginning of 2011, the four new Financial Market Supervisory bodies were able to start their work.

Meanwhile, on invitation of the European Council of March 2010, the so-called Van Rompuy Task Force elaborated a list of suggestions on how to improve economic and budgetary policy coordination. The Task Force was chaired by the new permanent Council President and brought together 27 (mostly) finance ministers. The Task Force delivered its report on improved budgetary and economic policy coordination and a permanent crisis resolution mechanism in October 2010. The European Commission tabled six legislative proposals (the so called "Rehn package") on September 27, 2010, just before the Van Rompuy report in order to make use of its right of initiative.

In March 2011, the European Council agreed that economic governance should be improved by implementing a so-called "Comprehensive Package" which includes the six legislative acts on budgetary, and economic policy coordination and national fiscal rules, the European Stability Mechanism (ESM) and the so-called Euro Plus Pact. The ESM, a permanent stabilization mechanism, is supposed to help solve future sovereign debt crisis in the euro area. Its implementation requires a revision of Art. 136 of the Treaty on the Functioning of the European Union (TFEU). The so-called Euro Plus Pact is an intergovernmental agreement, initially designed to commit the Heads of State and Government of the euro area to an ambitious economic and social reform agenda as well as budgetary austerity. It has meanwhile been signed by 23 out of 27 EU Member States.[1] In parallel to these efforts, further initiatives to improve financial market regulation are being pursued on the European level and in national contexts. Unlike the USA, where most of the measures to reform financial market regulation and surveillance were actually embedded in a single legislative initiative, the Dodd-Frank Act, financial market regulation in the EU is improved through multiple initiatives on different political levels.

The scope and pace of these legislative and institutional dynamics convey the (correct) impression that the euro area's governance rules and procedures are indeed undergoing substantial change. The question yet is whether the reforms undertaken are capable of eliminating the underlying governance weaknesses of the previous set-up.

[1] *The four non-members are the two EMU opt-out countries the UK and Denmark, as well as the likely future EMU members Hungary and the Czech Republic.*

2 Reforming an Incomplete Governance and Regulatory Framework

The way the financial crisis has hit the European Union since 2007 has revealed considerable weaknesses in the way its economic governance mechanisms functioned since the start of the European Monetary Union (EMU) in 1999. Weaknesses can be identified both in the way economic governance worked in the run up to the crisis and in the way the euro area handled crisis management.

First, the European Monetary Union was created with an *incomplete institutional and regulatory framework.* Initially, in parallel to the Intergovernmental Conference (IGC) which negotiated the Maastricht Treaty, a second ICG was held in order to equip the European Community and the future monetary union with a political union. But the latter failed and the European single currency was introduced with an accompanying governance framework. It essentially consisted of rules and procedures for budgetary and economic policy coordination judged at the time as being insufficient by many actors and observers. So several elements of the Maastricht framework were changed in different ways – long before the current reform process was launched and partly even before the euro was actually introduced. These changes include the Stability and Growth Pact of 1997 (and it first reform in 2005), the employment chapter in the Amsterdam Treaty of 1997, the creation of the Eurogroup and the subsequent introduction of the Eurogroup President, and well as the first euro area summit (held in 2008 under the French rotating EU Presidency). None of the initiatives substantially changed the nature of the governance mechanisms. No transfers of sovereignty occurred, and the rules-based coordination left room for political discretion to the Finance Ministers in the Ecofin Council.

Despite the various efforts to complete the governance framework over the years, it performed below expectations. Even before the crisis hit the EU in the last years, fiscal performance of many Member States did not reach the agreed targets and economic divergence within the euro area visibly built up.

There is of course the case to make that the *coordination mechanisms simply targeted the wrong variables.* For instance, the recent sovereign debt crises in Ireland and Portugal, would not have been prevented if the Stability and Growth Pact had been applied in every detail, not even in the new form once the "Rehn package" is passed, i.e. with tougher sanctions and swifter procedures. The exploding deficits and public debt levels were rather caused by the fact that the public sector shouldered liabilities of the private sector. Root causes were macro-economic imbalances, a decline of competitiveness and banking crises. The question then is why policy makers were immune to the increasing evidence that economic divergence increased in the euro area and that macro-economic imbalances persisted. The Broad Economic Policy Guidelines and the Macro-economic dialogue could have been used for closer economic policy coordination – had the political insight been there.

A major reason for insufficient policy co-ordination is without any doubt the nature of *incentive structures of national policy makers.* National decision makers in their majority have other interests than being "good EMU governors", they maximize utility in view of their objective to be re-elected in the next national election. Depending on the way the euro area and EU integration is perceived at home, part of their

electoral success in national or sub-national elections depends on their capacity to fend off interference from Brussels and to maintain the largest possible scope for national discretionary action.

If the assumption of short-termism and a focus on national constituencies holds true, this explains that *the perception of EMU realities* in national policy decisions is underdeveloped. Individual decision-makers either act uninformed because they simply do not grasp the interdependencies between national policy choices and euro area spill-overs, or they are cynic because they prefer to go ahead with solutions bringing short-term benefits home to domestic constituencies. Hence, for instance the possibilities for closer economic policy coordination that have existed ever since the euro was launched (e.g. through the Broad Economic Policy Guidelines or the Macro-Economic Dialogue) were not made use of by the Member States.

Quite the opposite is the case, national governments throughout the brief history of the European Monetary Union on several occasions stopped "more EU" in policy coordination and hence also *limited the impact of supranational actors in pushing EMU logics*. Hence, in particular, the European Commission encountered political obstacles in its efforts to implement budgetary policy coordination. While the first three years of EMU gave little reasons for doubt in the institutional set up, as of the year 2002 the Commission's political role in the coordination process actually eroded with the vivid Irish reaction to the criticism of its policies in the Broad Economic Policy Guidelines. In the following years it became increasingly obvious that the Commission depended on the support of the Ecofin, not only in the formal application of the Excessive Deficit Procedure and the Stability and Growth Pact, but also in more informal and subtle processes of policy coordination.

The Member States were unwilling to let their agent assume its role in budgetary and economic policy co-ordination in which the supranational impact was hence limited.

At the same time, *market mechanisms as disciplining devices proved insufficient* under the conditions of the euro area. In the run-up to the crisis, bond spreads for a considerable time did not reflect the respective Member States' fiscal and economic performance. So the basic logics of EMU's architecture, namely that markets would back the rules-based coordination, did not work. In the sovereign debt crisis, markets in a seemingly exaggerated reaction overshot and, once again, the rationality assumption does not hold. Since the crisis sovereign debt crisis and market reactions peaked in April/May 2010, the rescue packages, unclear political messages about private sector involvement and ongoing speculation about the likelihood and costs of sovereign defaults further blurred the conditions for markets to sanction irresponsible policies.

3 Methods and Actors of Economic Governance Reform in the EU between 2009 and 2011

The reform initiatives briefly outlined in the introduction have different legal bases, involve different actors and hence underlie different legal and political restrictions which determine their outcome.

Regarding the legal nature, a large part of the reforms consists of legislative action on the European level. This is for instance so for the "Rehn package", the laws installing the European Financial Market Supervision or the various initiatives to improve financial market regulation. Part of them is backed-up or completed by national legislation, for instance national law on financial market regulation or national fiscal rules.

Some of the legislative acts are passed under the ordinary legislative procedure which makes the European Parliament (EP) a full co-legislator. The EP has made its influence felt in both the negotiations of the Financial Supervisory bodies and the regulations concerning the Stability and Growth Pact and the reform of economic policy co-ordination, as it attempts to impose more European views on the Member States. Despite the shock induced by the financial crisis, which has revealed the degree of interdependency in the euro area, national considerations prevail when it comes to questions of sovereignty and interference from the EU level, for instance with the budgetary authority of national Parliaments. From a functional perspective "more European interference and coordination capacity" may seem to be the right way forward in order to reduce externalities and improve policy output. But looked at from the perspective of legitimacy, it becomes more and more obvious that attempts to limit national sovereignty and to transfer competencies to the EU level reach critical limits unless a sound base of legitimacy and democratic decision-making that satisfies Western European norms is guaranteed.

The European Stability Mechanism, in contrast, is based on an intergovernmental Treaty which has been signed by all euro area Member States and now has to undergo ratification in national Parliaments. In order to make the ESM compatible with the EU Treaty, Art. 136 TFEU has been amended – another step that requests national ratification. From today's perspective, it cannot be excluded that the ESM Treaty or the amendment of the TFEU encounter ratification problems in single Member States.[2]

The Pact for the Euro-Plus, meanwhile is an intergovernmental agreement between the 24 signatory Member States. While coordination in particular with the new policy coordination

[2] *See for instance the political power play in Slovakia which has already opted out of the EFSF. http://spectator.sme.sk/articles/view/43089/10/government_approves_esm_documents_with_sas_party_against.html (retrieved on June 15, 2011).*

mechanisms installed with the "Rehn package" and the European Semester is supposed to be close, the Euro Plus Pact still provokes the formation of a new group within the European Council excluding large players such as the UK.

4 The Political Context of Economic Governance Reform in 2010/2011

The sheer number of initiatives undertaken in order to reform economic governance of the euro area and the substance of at least some of the measures show that *a window of opportunity* has opened with the advent of the financial crisis and in particular with the development of the sovereign debt crisis. While all reservations on political feasibility of far reaching efforts outlined above apply, it can still be argued that the political context for reform has been rather supportive since 2009. But the tide may very soon turn if Member States become even more self-interested, in particular if the economic and social costs of the crisis continue to weigh on governments.

The political context for EMU governance reform in 2011 can hence be characterized as follows. As a general mood, on the EU level, the focus is on *risk management and prevention,* but there is little ambition for joint policy making. This attitude became apparent when the real economic effects of the crisis hit in 2009 and there was little political will among the Member States' governments to coordinate the fiscal stabilization efforts more closely or launch a European initiative. Moreover, the reluctance to link policy debates, e.g. in connection with the upcoming EU budget negotiations and the European growth strategy "EU 2020", to the question of governance reform and sovereign debt crisis resolution, is telling. Governments continue not to be open for stronger political coordination, even if the euro area underperforms as a whole.

Declining Solidarity and Rising Polarization

With the growing reluctance to participate in the rescue mechanisms (cp. the case of Slovakia, the True Fins and the concerns about Germany's long-term involvement with the mechanisms) and with a (in key countries) declining support for EU membership, there is a concern that previous *assumptions on necessary solidarity and cohesion in the E(M)U could be revised to the bottom.* If this is so, this will not only have implications for the creditor countries adherence to the newly installed rescue mechanisms. It would furthermore impact the upcoming negotiations on the EU's multi-annual financial framework and hence the future of the cost-intensive policies such as cohesion and structural policies.

The crisis has provoked *unparalleled polarization and polemics between Member States* (cp. for instance the polemics both in Germany on the Greek and in Greece on the Germans). If the EU runs into a situation where the donor and recipient countries face each other with hostility and mistrust, the political and normative fundaments of the European integration process may be shattered. This is particularly so as competitive pressures and substantial real devaluations cause political backlash in some countries. Political fragmentation, the inability to construct cross-party consensus on far reaching structural changes and rising populism not only make it questionable whether governments of recipient countries will actually be able to stick to the conditionality they have signed in return for rescue packages. Polarisation will increase if the pain of structural reform and bud-

getary austerity is increasingly blamed on the "dictatorship of the donors".[3]

The *evolution of public opinion* indeed becomes a growing concern. Low growth and high unemployment rates since the beginning of European integration tend to correlate with a decline of support for European integration. Meanwhile, opinion poll data also shows rising expectations of the citizens towards the EU's problem-solving capacity in economic and social policy. Taken together, these two trends bear a risk of frustration with the EU and national politics and hence may feed populist tendencies in moderate parties or (anti-EU) populist movements. There is consequently, in the short term, a rising importance of active opinion leadership and public deliberation.

5 Outlook

Despite the broad economic governance reform agenda of which the major parts will be concluded in 2011, the EU is likely to stay in a transitory phase for further years. The reason is that the current reforms stop short of creating governance structures that are likely to ensure legitimacy on the input and on the output side of the policy cycle. Meanwhile, the crisis management and the new governance structures are a substantial departure from the Maastricht model of EMU in which the ECB exclusively focused on monetary stability while the governments were – at least in theory – assumed to have full liability for budgetary policy making.

So in the long run, the euro area's *reform agenda may need to be defined in much broader terms.* Both the problems of the political economy of policy coordination discussed above and the problems of legitimacy that the EU will increasingly encounter, make the case for a much deeper questioning of the governance mechanisms than the current reform projects do. In the long run, the conclusion may well be that a European currency cannot survive without an European economic government whose basis of legitimacy is solidly founded in a European democracy.

[3] *An expression used by Daniel Gros in a public hearing of the Budgetary Committee of the Deutscher Bundestag on March 14, 2011.*