# Policy-Making in the European Union

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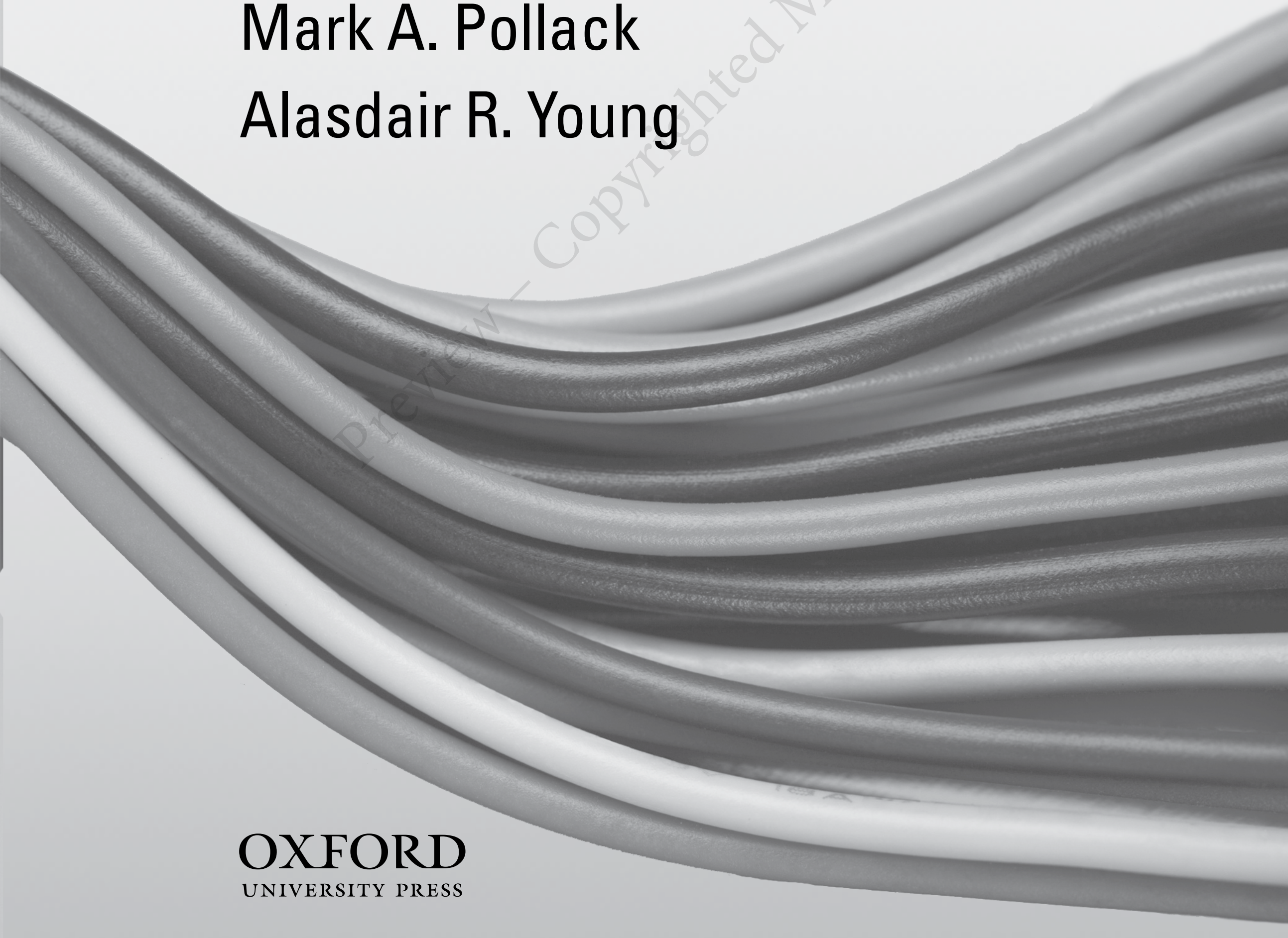

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CHAPTER 7

# Policy-Making under Economic and Monetary Union

## Crisis, Change, and Continuity

*Dermot Hodson*





## Summary

Economic and monetary union (EMU) provides the European Union (EU) with a major role in macroeconomic policy-making. As of 2015, nineteen members of the euro area have exchanged national currencies for the euro and delegated responsibility for

*(continued...)*

monetary policy and financial supervision to the European Central Bank (ECB). Member states have also agreed to coordinate their budgetary policies and structural reforms, to provide financial assistance to member states facing fiscal crises, and to speak with one voice on international issues. EMU is a high-stakes experiment in new modes of EU policy-making insofar as the governance of the euro area relies on alternatives to the traditional Community method, including policy coordination, intensive transgovernmentalism, and delegation to de novo bodies. This experiment has suffered a number of setbacks since the launch of the euro in 1999, not least following the global financial crisis of 2007–8. The crisis has served as a catalyst for comprehensive reforms to policy-making in EMU, which some see as paving the way for a more centralized approach to economic policy but which provide no evidence of a return to the Community method thus far.



## Introduction

Macroeconomic policy is a province of public policy that has traditionally been closely guarded by national politicians, civil servants, and central bank officials.[1] It typically entails the setting of short-term interest rates (monetary policy) and decisions related to government expenditure and taxation (fiscal policy) and can include measures designed to influence the external value of the currency (exchange-rate policy). Macroeconomic policies are closely intertwined with structural reforms and financial market policies. Structural reforms include regulatory changes aimed at improving the functioning of product and labour markets. Financial market policies encompass the regulation and supervision of banks and other financial institutions. The goals of macroeconomic policy include the pursuit of price stability, higher economic growth, sound public finances, and the smooth functioning of both the balance of payments and the financial system. These are technical goals, to be sure, but the difference between meeting and missing them can have a profound effect on people's standards of living.

EMU entails a radical shift in macroeconomic policy-making in the EU. As of 1 January 2015, nineteen euro area countries—Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain—have exchanged their national currencies for the euro and delegated responsibility for monetary policy to the ECB. Member states have retained varying degrees of control over the other aspects of macroeconomic policy, although they have agreed to coordinate these policies in informal settings such as the Eurogroup and euro summit. National governments have, in addition, accepted limits on how much they can borrow under the Stability and Growth Pact (SGP) and agreed to coordinate fiscal policies and structural reforms via a patchwork of procedures. They have also, following the global financial crisis of 2007–8, created the European Stability Mechanism (ESM) to provide financial assistance to euro area members and launched a single supervisory mechanism for euro area banks as part of plans for European banking union (see Chapter 5).

EMU has a threefold significance for students of EU policy-making. First, the single currency is among the most tangible symbols of European integration for the 335 million people who live in the euro area. Secondly, the euro is a major global currency that is second only to the US dollar in terms of its international usage, making EMU central to the EU's ambitions to become a leading player on the world stage. Thirdly, and critically for the themes of this volume, EMU is a high-stakes experiment in new modes of EU policy-making. As discussed in Chapter 4, the traditional Community method involves the delegation of key responsibilities to the Commission. Under EMU, responsibility for monetary policy and financial supervision have been delegated to a new kind of supranational institution, the ECB, and the ESM has been given a key role in the management of financial crises. Other elements of economic policy—most noticeably those concerning fiscal policy and structural reform—can be seen as a pioneering attempt at policy coordination among national governments. The euro summit and the external representation of the euro area, meanwhile, are closer to intensive transgovernmentalism.

This chapter explores the origins and evolution of EMU as the euro approaches its third decade. The first section puts the creation of EMU in historical context. The second looks at the economic performance of the euro area from 1999 to EMU's sovereign debt crisis. The third section looks at the ECB and the ESM as variations on the Community method. The fourth section takes stock of EMU's experiment with policy coordination and the manifold reforms to euro area governance in the light of the global financial crisis. The fifth section views the emergence of the Eurogroup and the euro summit and EMU's fragmented system of external representation through the lens of intensive transgovernmentalism.



## The origins of economic and monetary union

The 1957 Treaty of Rome (EEC) contained few references to macroeconomic policy and no reference to EMU (see Table 7.1 for a chronology). One reason why the treaty did not go further here was that the Keynesian consensus that held sway among economists at the time stressed the need for national control of macroeconomic policy instruments. Specifically, governments were expected to trade off higher inflation for lower unemployment and, in the event of an economic downturn, to stimulate aggregate demand through a combination of tax cuts, expenditure increases, and interest rate reductions. Another relevant factor was that member states chose not to challenge the Bretton Woods Agreement of 1944, which sought exchange-rate stability among industrial countries by linking the US dollar to gold and linking national currencies to the dollar (see Maes 2004).

**TABLE 7.1 Chronology of EMU (Part 1)**

| | |
|---|---|
| July 1944 | Bretton Woods Agreement signed |
| Mar. 1957 | Treaty of Rome signed |
| Oct. 1970 | Werner Group adopts its final report |
| Mar. 1971 | Member states agree to three-stage plan for EMU |
| Mar. 1973 | Collapse of the Bretton Woods system |
| Mar. 1979 | Launch of the European Monetary System (EMS) |
| Apr. 1989 | Delors Committee adopts its final report |
| July 1990 | Stage 1 of EMU begins |
| Feb. 1992 | Treaty on European Union signed at Maastricht |
| Sept. 1992 | Italy and the UK exit the exchange-rate mechanism (ERM) |
| Aug. 1993 | Reform of the ERM |
| Jan. 1994 | Stage 2 of EMU begins |
| June 1997 | European Council in Amsterdam adopts the SGP |
| Dec. 1997 | European Council in Luxembourg creates the Eurogroup |
| May 1998 | EU leaders decide that 11 member states have met the convergence criteria; ECB established |
| Jan. 1999 | Stage 3 of EMU begins and the euro area is created |



In December 1969, EEC leaders invited the Luxembourg prime minister, Pierre Werner, to work out a plan for EMU. This plan was part of European attempts to address the global macroeconomic imbalances that emerged under the Bretton Woods system (James 2012: 2). These imbalances occurred, in part, because the US could no longer maintain the dollar's link with gold amid the inflationary effects of the Vietnam War. There were also concerns at the time that flexible exchange rates would disrupt trade relations within the EEC and make the common agricultural policy more costly (Commission 1969).

The Werner Plan was adopted in 1971 but abandoned after member states' initial attempts at exchange-rate cooperation foundered following the disintegration of Bretton Woods in 1973 and the oil crisis that same year. In 1979, EEC member states made a fresh attempt at exchange-rate cooperation through the European Monetary System (EMS). The centrepiece of the EMS was the exchange-rate mechanism (ERM), which was designed to minimize fluctuations among national currencies. A weighted basket of EEC currencies, the European currency unit (ecu), was used as the denominator for this system. The EMS had its ups and downs but it helped to promote exchange-rate stability and to reduce inflation, especially in the second half of the 1980s when national governments resorted less frequently to the practice of devaluing their currencies.

McNamara (1998) links the creation of the EMS to member states' move towards monetarism from the mid-1970s onwards. Monetarism challenged Keynesianism by rejecting the existence of a long-term trade-off between growth and employment and prioritizing the pursuit of low inflation through restrictions on money-supply growth. The ERM, McNamara argues, was viewed as a commitment device for achieving monetarism's primary objective of price stability. A case in point was France, where President François Mitterrand used the ERM to reinforce his efforts to reduce inflation and restore macroeconomic credibility after abandoning Keynesianism in 1983.

In June 1988, the European Council asked the Commission president, Jacques Delors, to lead a high-level committee comprised chiefly of central bank governors to draw up a fresh plan for EMU. Using this plan as a starting point, EU leaders adopted a three-stage transition to EMU that was enshrined in the Treaty on European Union (TEU), signed at Maastricht in 1992. Stage 1 (1990–4) included the removal of the remaining barriers to the free movement of capital and the granting of political independence to central banks. Stage 2 (1994–8) required member states to demonstrate their commitment to macroeconomic discipline by meeting convergence criteria (see Table 7.2). It also saw the launch of the Broad Economic Policy Guidelines (BEPGs), a set of non-binding recommendations on the economic policies of the member states and the Community proposed by the Commission and



**TABLE 7.2 Summary of the convergence criteria**

| What is measured? | How is it measured? | Convergence criteria |
|---|---|---|
| Price stability | Harmonized index of consumer prices (HICP) | Not more than 1.5 percentage points above the three best performing member states |
| Sound public finances | Government deficit as % of GDP | Reference value: not more than 3% |
| Sustainable public finances | Government debt as % of GDP | Reference value: not more than 60%; if above this reference value, government debt should have sufficiently diminished and must be approaching 60% at a satisfactory pace |
| Durable convergence | Long-term interest rates | Not more than 2 percentage points above the three best performing member states in terms of price stability |
| Exchange-rate stability | Deviation from a central rate | Participation in ERM II for two years without severe tensions |

Source: Commission (2008*d*: 8) © European Union, 1995–2014.

endorsed by EU finance ministers. Stage 3 (1999 onwards) included the irrevocable fixing of exchange rates and the creation of the ECB. In keeping with the new classical economics, the intellectual successor to monetarism in the 1980s, the treaty tackled concerns about the ability of short-sighted governments to make the right long-term choices for the economy. The treaty did this, first, by guaranteeing the ECB's independence from political control and, secondly, through the excessive deficit procedure, which prohibits member states from running budget deficits in excess of 3 per cent of gross domestic product (GDP).

European integration scholars are divided as to the rationale for resuscitating plans for EMU at this time (see Sadeh and Verdun 2009). Neo-functionalists emphasize the importance of spill-over from prior stages of economic integration. Padoa-Schioppa (2000), for example, argues that the single European market programme (see Chapter 5) forced member states to choose between EMU and flexible exchange rates because the free movement of capital rendered the EMS unworkable. Intergovernmentalists, in contrast, explain EMU as the outcome of interstate bargaining. In a variation on this theme, Moravcsik (1998) views EMU as an attempt by national governments, motivated primarily by economic interests, to lock in the benefits of macroeconomic stability at the EU level. The benefits of this enterprise, he argues, were modest for Germany because of the privileged position of the deutschmark in the EMS. For Moravcsik, this explains why the TEU enshrined macroeconomic principles that enjoyed a high degree of support among German policy-makers, especially the overriding importance attached to price stability.

Economists have generally been more circumspect than political scientists about the *ex ante* economic rationale for EMU. Following Mundell (1961), the prevailing view in the 1980s and 1990s was that European countries would struggle to form an optimum currency area (OCA) because of the prevalence of asymmetric shocks (economic disturbances that affect different countries in different ways) and the perceived lack of flexibility in product and labour markets. Of course, the logic of OCA theory is not undisputed. Mundell himself later warned that floating exchange rates could be a cause of, rather than a cure for, macroeconomic instability as national financial markets become more integrated (De Grauwe 2006). Furthermore, the macroeconomic costs of giving up national exchange rates must be weighed against the microeconomic benefits of monetary union, which include the elimination of exchange-rate uncertainty, the transaction cost savings of doing business in one currency, and the competitive gains from increased price transparency between countries (De Grauwe 2012).

In the early 1990s, preparations for EMU hit a stumbling block when a combination of German unification and falling economic growth and rising unemployment in the rest of the Community generated significant strains within the EMS. Following intense currency speculation, Italy and the UK were forced to suspend their membership of the ERM in September 1992. A year later, the ERM was made much less binding after the remaining member states adopted extra-large margins of fluctuation between their currencies. In May 1998, EU leaders finally agreed that eleven member states—Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain—fulfilled the convergence criteria and could proceed to Stage 3 of EMU. The inclusion of Belgium and Italy on this list was politically controversial since public debt in these countries, though it was diminishing in line with the treaty requirements, exceeded 100 per cent of GDP.

The European Council took a number of steps on the eve of the euro's launch to strengthen economic policy coordination. In June 1997, the heads of state and government signed the SGP, an agreement designed to reinforce the TEU's excessive deficit procedure. In December of the same year, the European Council agreed that the finance ministers of euro area members could meet informally with representatives of the ECB in attendance in a forum that would come to be known as the Eurogroup. In July 1998, EU finance ministers adopted the first set of country-specific recommendations under the BEPGs. Although these recommendations were non-binding, they signalled the EU's growing interest in public finances; product, labour, and capital market reforms; and other aspects of member states' economic policies.

This intensification of policy coordination can be seen as a response to the twin problems of adjustment and spill-over under EMU. The problem of adjustment follows from OCA theory insofar as the irrevocable fixing of exchange rates within a monetary union leaves its members dependent on fiscal policy and relative prices and wages to adjust to asymmetric shocks. The problem of spill-over refers to the possibility that policy decisions taken in one member of a monetary union could generate negative externalities for other members. Seen in these terms, the SGP sought to reconcile the problems of adjustment and spill-over by encouraging member states to run only modest budget deficits. The pursuit of product and labour market reforms through the BEPGs, meanwhile, can be understood as an attempt to encourage greater flexibility in price- and wage-setting in readiness for asymmetric shocks (Calmfors 2001). Taken together, these arguments for policy coordination owe a debt to the new Keynesian paradigm that emerged in the 1990s, with its emphasis on tying governments' hands through fiscal rules and its preoccupation with product and labour market reforms (see Schelkle and Hassel 2012).



## From the launch of the single currency to the sovereign debt crisis

The euro became legal tender on 1 January 1999 alongside the creation of the ERM II, an exchange-rate regime in which member states aspiring to adopt the single currency agree to minimize fluctuations between their currencies and the euro (see Table 7.3 for a continued chronology of EMU). Greece joined the euro area in January 2001, twelve months before the changeover from national currencies to euro notes and coins. In January 2007, Slovenia became the first of the EU's 'new' member states to join the euro, followed by Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, and Lithuania in 2015.

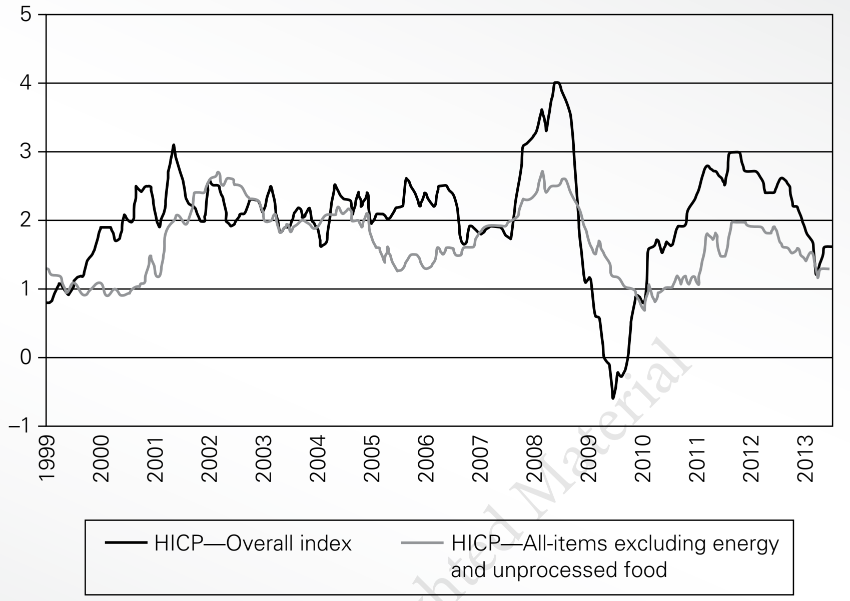
**TABLE 7.3 Chronology of EMU (Part 2)**

| | |
|---|---|
| Jan. 2001 | Greece joins the euro area |
| Jan. 2002 | Changeover to euro notes and coins |
| Mar. 2005 | European Council in Brussels revises the SGP |
| Jan. 2007 | Slovenia joins the euro area |
| Jan. 2008 | Cyprus and Malta join the euro area |
| Jan. 2009 | Slovakia joins the euro area as the euro marks its tenth anniversary |
| May 2010 | EU–IMF financial support package for Greece |
| May 2010 | European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) established |
| Nov. 2010 | EU–IMF financial support package for Ireland |
| Dec. 2010 | European Systemic Risk Board (ESRB) established |
| Jan. 2011 | Estonia joins the euro area |
| May 2011 | EU–IMF financial support package for Portugal |
| Oct. 2011 | Euro summit established |
| Dec. 2011 | Six-pack enters into force |
| Feb. 2012 | ESM Treaty signed |
| Mar. 2012 | Fiscal compact signed |
| June 2012 | EU financial support package for Spain |
| Sept. 2012 | ECB unveils outright monetary transactions |
| Oct. 2012 | ESM inaugurated |
| Mar. 2013 | EU–IMF financial support package for Cyprus |
| May 2013 | Two-pack enters into force |
| Jan. 2014 | Latvia joins the euro area |
| Jan. 2015 | Lithuania joins the euro area |



The first decade of the single currency was successful in terms of achieving EMU's headline goal of maintaining price stability. The annual rate of consumer price inflation between 1999 and 2008 was just 2.2 per cent (see Figure 7.1), which is low by historical standards and close to the ECB's target (see next section). Although consumer prices were stable overall, this picture masked macroeconomic imbalances elsewhere in the euro area. A case in point was Ireland, which saw property prices grow by an average rate of 10 per cent per annum in real terms between 1999 and 2007 (OECD 2013). EMU may have been partly to blame here. If Ireland had not been a member of the euro area, then the Central Bank of Ireland could have increased interest rates, which in turn would have reduced the runaway demand for mortgages. Be that as it may, Irish financial authorities could have addressed excessive risk-taking by banks and individuals but they chose not to do so (Nyberg 2011).

**FIGURE 7.1 Harmonized index of consumer prices, Jan. 1999–August 2013 (percentage change on previous period)**




Source: ECB Statistical Data Warehouse.



The euro area's growth performance during the first decade of EMU was disappointing. GDP growth averaged 2.1 per cent between 1999 and 2008, which is lower than in previous decades and compared to the performance of other industrialized economies (Table 7.4). Also worrying were persistent differences in growth rates across euro area members during EMU's first decade. Whereas Ireland, Greece, and

**TABLE 7.4 Gross domestic product at 2000 market prices (average annual percentage change)**

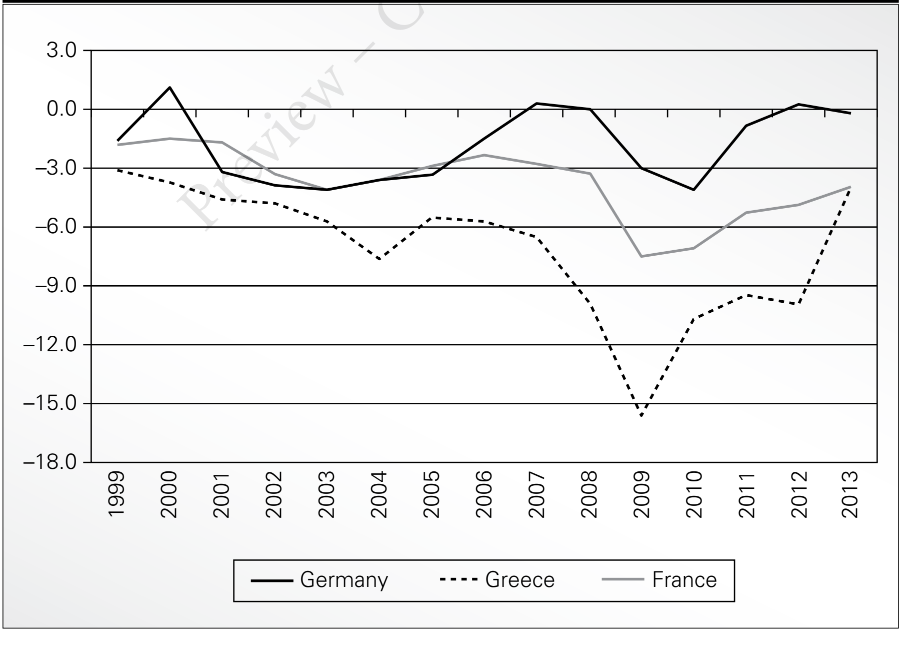
| | 1961–70 | 1971–80 | 1981–90 | 1991–8 | 1999–2008 | 2009–13 |
|---|---|---|---|---|---|---|
| Euro area | 5.3 | 3.4 | 2.4 | 1.7 | 2.1 | –0.4 |
| UK | 2.8 | 2.0 | 2.8 | 2.8 | 2.7 | –0.1 |
| US | 4.2 | 3.3 | 3.2 | 3.7 | 2.5 | 1.0 |
| Japan | 10.2 | 4.5 | 4.6 | 0.9 | 1.1 | 0.4 |

Source: Commission 2014*e*.

Spain posted very high rates of GDP growth throughout, member states such as Portugal, Italy, and Germany recovered slowly from the downturn of 2001–2. That these differences did not dissipate more quickly was seen by some economists as evidence that member states were adjusting too slowly to asymmetric shocks, in keeping with the optimum currency area critique of EMU (Commission 2006*a*). For Hancké (2013), wage-setting proved to be particularly problematic in this regard. EMU's first decade produced serious macroeconomic imbalances, he argues, because economies in the core of the euro area (most noticeably Germany) relied on modest wage rises to boost the competitiveness of their exports, while those on the periphery (e.g. Greece) let their wages rise rapidly and lost competitiveness as a result.

EMU's first decade was also marked by a lack of fiscal discipline by euro area members. Problems began when some member states failed to reduce their government borrowing sufficiently during the economic upturn of the late 1990s in spite of periodic pleas to do so by the Commission and the Council of Ministers for Economic and Financial Affairs (Ecofin). As a consequence, France and Germany, among others, posted excessive deficits once economic conditions slowed in 2001–2. Although these member states had reduced their budget deficits to below 3 per cent of GDP by 2008 (see Figure 7.2), government debt as a percentage of GDP remained high in many cases and in triple digits in Belgium, Italy, and Greece (Commission 2013*f*). There was also, with the benefit of hindsight, a serious problem of statistical governance in Greece. The magnitude of this problem became clear in October 2009 when

**FIGURE 7.2 Net government lending, 1999-2013 (percentage of GDP at market prices)**



the newly elected government of George Papandreou announced that the country's budget deficit was much higher than previously indicated (Panagiotarea 2013: 129). As a result, the Greek budget deficit was close to 10 per cent by the time that the single currency celebrated its tenth anniversary (see Figure 7.2).

The world experienced financial turmoil in 2007 and 2008 on a scale that had not been witnessed since the Wall Street Crash of 1929. The crisis has variably been attributed to global macroeconomic imbalances (see Obstfeld and Rogoff 2009) and financial innovation (Crotty 2009) among other factors. The immediate trigger, however, was the collapse of the US subprime loan market after borrowers who had been granted loans in spite of their poor credit ratings struggled to make repayments as house prices plummeted (Shiller 2008). This crisis sowed the seeds for a global credit crunch as inter-bank markets froze and loans to businesses and individuals dried up. This credit crunch was followed by a banking crisis after Lehman Brothers, a major US investment bank, filed for bankruptcy in September 2008 as a result of subprime-related losses. This crisis engulfed European banks and the failure of euro area members to rescue cross-border banks such as Fortis—and before that to prevent precarious business practices by such institutions—exposed significant shortcomings in EU financial market regulation and supervision (Quaglia, Eastwood, and Holmes 2009).

In October 2008, EU member states agreed to set aside €2 trillion to rescue Europe's distressed banks alongside new rules on deposit insurance to protect savers. These measures helped to stabilize European banks in the short term but credit shortages and a sharp contraction in world trade sowed the seeds for a severe recession. No euro area member was immune from this sudden slowdown, but those that entered the financial crisis with serious macroeconomic imbalances were, by and large, the hardest hit. In Germany, for example, GDP fell by 5.1 per cent in 2009 (Commission 2013*f*), but rebounded rapidly the following year thanks, in part, to the country's room for fiscal stimulus and its impressive external competitiveness. Recovery was much slower to materialize in member states that saw housing bubbles burst or entered the crisis with high levels of government borrowing. Ireland, for instance, began the crisis with a balanced budget but saw government borrowing reach an astonishing 30.8 per cent of GDP in 2010 after house prices plummeted and the government stepped in to guarantee the country's troubled banks (Commission 2013*f*). House price falls were more modest in Greece but the country posted a budget deficit of 15.6 per cent in 2009 after its aforementioned sins of statistical omission came to light (Commission 2013*f*).

By the beginning of 2010, budget deficits in Greece, Portugal, Ireland, and Spain were close to or above 10 per cent. As a result, the global financial crisis paved the way for a euro area sovereign debt crisis as financial markets lost confidence in the ability of governments in these countries to honour their national debts. As a result, long-term interest rates on government debt soared, reinforcing concerns over sovereign default. It was clear that euro area member states would require financial assistance to break this vicious cycle.

**BOX 7.1 Economic adjustment in Greece**

The economic adjustment programme signed by Greek authorities in May 2010 identified a detailed set of expenditure cuts, tax increases, and structural reforms designed to get government borrowing under control. These measures included controversial commitments to cut the entitlements of civil servants, increase value-added tax rates, and prepare of a plan for the sale of state-owned assets. Not all these measures were implemented in full, but the degree of fiscal adjustment that followed was well above the norm for programmes of this sort (IMF 2013*a*: 20). Greece's cyclically adjusted primary balance—a measure of government borrowing—improved by 15 percentage points between 2009–13 with the result that a primary budget surplus (a key condition for reducing overall debt levels) was in sight (IMF 2013*b*: 4). Whether this medicine was the right one is a matter of fierce debate among economists, but even those who see such fiscal adjustment as unavoidable cannot deny its devastating impact on the Greek economy in the short term. Between 2009 and 2013, the Greek economy contracted by 21 per cent and unemployment rose from 9.5 to 27 per cent of the civilian labour force (European Commission AMECO Database).

Still, it took until May 2010 for EU leaders to agree on a package of €110 billion loans for Greece. These loans were co-financed by EU member states and the International Monetary Fund (IMF) with the disbursal of loan instalments contingent on compliance with an economic adjustment programme (see Box 7.1) overseen by officials from the 'troika' of the Commission, the ECB, and the IMF.

One reason for the delay over Greece was that the balance of payments support, originally envisaged by the EEC and now codified in Article 143 TFEU, applies only to member states that had not adopted the single currency. Thus, while the EU provided emergency loans to three euro outs, Hungary, Latvia, and Romania, in 2008–9, it could not offer similar support to Greece. Another reason was that EU policy-makers could not initially agree on involving the IMF (see Hodson 2011). Euro outs such as the UK were keen to minimize their exposure to the sovereign debt crisis and so emerged as early champions of involving the IMF. France, among others, was wary of doing so because it feared for the euro area's autonomy and prestige if it looked to a third party for financial support and economic advice. Germany had a decisive say in such debates since it stood to be the largest contributor to any loan package and Chancellor Angela Merkel eventually insisted that the EU must join forces with the IMF.

The EU and IMF package of loans allowed Greece to finance its public debt without resorting to financial markets, but in return Greek authorities committed to a drastic set of austerity measures designed to get government borrowing under control. Within days, the heads of state and government agreed to offer similar terms to other euro area members via two ad hoc stability mechanisms. The first was the €60 billion European Financial Stability Mechanism (EFSM). The second was the €440 billion European Financial Stability Facility (EFSF). Ireland became the first member state to access these funds in November 2010 as part of an EU–IMF package worth €85 billion. Portugal was next, securing €78 billion in loans from the EU and IMF in May 2011. In October 2012, a new permanent stability mechanism, the ESM, was launched with a lending capacity of €500 billion. Spain became the first member state to benefit from this instrument after euro area finance ministers agreed to set aside €100 billion to help to cover the cost of recapitalizing the country's banks. Cyprus received €9 billion in loans from the ESM alongside €1 billion from the IMF in March 2013 after the government found itself with insufficient resources to support the country's bloated financial sector.[2]

It is too soon to evaluate the impact of emergency financial support for euro area members but an interim assessment is unavoidably ambiguous. In its *ex post* evaluation of Greece's first financial support programme—it received a second round of loans in March 2012 and could yet require a third—the IMF saw the defence of the country's membership of the euro area as a key success (IMF 2013*a*). This shows the high stakes surrounding a crisis in which the exit of one or more member states from EMU with potentially fatal consequences for the euro was not, and is still not, beyond the bounds of possibility. It also raises the question of whether continued membership of EMU was worth the pain. A national currency is not a panacea as Greece's fiscal crises in the pre-EMU period show (see Reinhart and Rogoff 2009), but the economic and fiscal adjustment undertaken by Greece in exchange for financial support was severe (see Box 7.1). No member state that sought external financial assistance during the sovereign debt crisis escaped the harsh effects of fiscal austerity but most did better than Greece in the short term. Ireland fared best—or, at any rate, least badly—by meeting its fiscal adjustment targets more or less as planned and resuming economic growth in 2011. In December 2013, the Irish government became the first in the euro area to exit an EU–IMF programme, leaving it reliant once again on financial markets to finance its debt.

Financial support for euro area members saved the single currency in the short term but it ultimately failed to convince financial markets that the sovereign debt crisis was under control. This is one reason why the ECB belatedly agreed in July 2013 to undertake an unlimited programme of government bond purchases through its outright monetary transactions (OMT) programme. This was a much more credible commitment than the provision of financial support via large but limited pots from the EU and IMF and financial markets reacted favourably.

That said, the OMT addressed neither concerns about the continued exposure of national governments to troubled financial institutions nor the root causes of the sovereign debt crisis. On the first of these points, euro area finance ministers agreed in June 2013 that the ESM could lend directly to banks, meaning that national governments would not directly bear the costs of bank bailouts; the absence of such a mechanism was a key reason why Ireland, Spain, and Cyprus found themselves on the brink of sovereign default after stepping in to support troubled financial institutions.

On the second point, EU member states agreed on a set of major reforms to EU economic governance, including the six-pack, two-pack, fiscal compact, and European semester (see Table 7.5 for an overview, and the section on EMU and

**TABLE 7.5 New macroeconomic governance mechanisms after the financial crisis**

| Date* | Title | Description |
|---|---|---|
| May 2010 | European Financial Stabilization Mechanism | Ad hoc stability mechanism created under Art. 122 TFEU used to provide financial support to Ireland and Portugal |
| May 2010 | European Financial Stability Facility | Ad hoc stability mechanism created under an intergovernmental agreement used to provide financial support to Ireland, Portugal, and Greece |
| Jan. 2011 | European semester | A revised annual timetable for EU economic surveillance designed to discuss national economic policies before they are adopted by member states |
| Jan. 2011 | European Systemic Risk Board | An EU-level body created under Art. 127(6) TFEU with responsibility for financial stability in the Union, comprised chiefly of national supervisors and chaired by the ECB president |
| Dec. 2011 | Six-pack | A set of five EU regulations and one directive adopted under Arts. 121, 126, and 136 TFEU and designed to reinforce the SGP and other elements of economic policy coordination |
| Nov. 2012 | Fiscal compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) | An intergovernmental treaty ratified by 25 member states as of Jan. 2014 to reinforce national fiscal rules and other aspects of economic policy coordination |
| Oct. 2012 | European Stability Mechanism | A permanent stability mechanism underpinned by Art. 136 TFEU but created under an intergovernmental agreement used to provide financial support to Spain and Cyprus |
| May 2013 | Two-pack | A pair of EU regulations adopted under Arts. 121 and 136 TFEU and designed to reinforce the SGP other elements of economic policy coordination |
| Nov. 2014 | Single Supervisory Mechanism | A mechanism created under Art. 127(6) TFEU that gives the ECB new powers of financial supervision in relation to euro area members and participating EU member states |

* Established or in the case of the European semester, fiscal compact, six-pack, and two-pack entered into force.

policy coordination later in the chapter for more detail). These reforms were accompanied by the search for a new approach to financial supervision in the EU. This led to the creation of a new European Systemic Risk Board (ESRB) in January 2011 followed in October 2013 by a more ambitious agreement to delegate responsibility for banking supervision to the ECB (see the following section) as part of wider plans for European banking union (see Chapter 5). On balance, these reforms leave the euro area less vulnerable to future financial turmoil but their ability to tackle the after effects of the 2007–8 financial crisis remains an open question, the answer to which will determine the political fate of the euro.

## Variations on the Community method

Policy-making under EMU is based not on a single style of decision-making but on new modes of EU policy-making that depart in different ways from the Community method (see Chapter 4). Monetary policy under EMU and, more recently financial supervision, chime with the traditional Community method since they involve the delegation of significant decision-making powers to a supranational institution. At the same time, the ECB is more akin to an autonomous EU agency than a traditional Community body such as the European Commission. The ESM is more unusual still, operating as it does at one remove from the Community's treaty and decision-making structure.

### The ECB

Like the Commission, the ECB has a legal personality (Art. 9, Protocol 4 TFEU) and the right to formulate opinions, deliver recommendations, and make regulations on policies that fall within its sphere of competences (Art. 34, Protocol 4 TFEU). Even more so than the Commission, the ECB's political authority is closely linked to its credibility and technocratic expertise due, in part, to the intense scrutiny of monetary-policy decisions by financial markets.

In spite of such similarities, there are significant differences between the ECB and the Commission. A distinctive feature of the ECB is its comparatively decentralized decision-making structure, which allows national central bank (NCB) governors a seat on the ECB Governing Council alongside the ECB president, vice-president, and four other members of the ECB Executive Board (Art. 10, Protocol 4 TFEU). When it comes to the setting of short-term interest rates, each member of the Governing Council initially had the right to cast one vote, and decisions were based on a simple majority. After the number of euro area members exceeded eighteen, the total number of votes on the ECB Governing Council was capped at twenty-one. Executive Board members retain their voting rights permanently, with the remaining fifteen voting rights rotating among NCB governors (see Hodson 2010). Even after these reforms, EMU remains an extreme example of what Blinder (2007) calls monetary policy by committee. Committees, he notes, can lead to better informed and less ideologically driven decision-making (Blinder 2007), although the sheer size of the ECB Governing Council raises concerns that it will act too conservatively (Gros 2003). By conservative, economists mean here that the ECB is likely to attach more weight to price stability than the pursuit of higher economic growth and that the bank will be otherwise slow to act in a crisis.

The ECB is also subject to fewer checks and balances than the Commission. Members of the ECB Executive Board are appointed for an eight-year, non-renewable term of office on the basis of a common accord by member states following consultation with the European Parliament (EP) and the ECB Governing Council (Art. 11, Protocol 4 TFEU). In practice, appointments are dominated by deals among the largest euro area members. This was evident when Germany's preferred choice as the first president of the ECB, Wim Duisenberg, was appointed in May 1998, but agreed to stand down early in 2003 to make way for France's choice, Jean Claude Trichet. The Governor of the Banca d'Italia, Mario Draghi, succeeded Trichet as ECB president in November 2011 after France and Germany failed to field a candidate, but political manoeuvring was evident once again in the decision shortly afterwards to replace ECB Executive Board member Lorenzo Bini Smaghi, an Italian, with Benoît Cœuré, a Frenchman, thus ensuring that France retained a seat on this key decision-making body. The EP can force the resignation of the college of commissioners, but it can do little more than invite the ECB president to appear before its committees (Art. 284 TFEU). In this sense, the EP's formal role in EMU is minor compared to some other areas of EU policy-making. Also important in this context is the fact that the ECB is located in Frankfurt rather than Brussels, Strasbourg, or Luxembourg, thus allowing it to operate at one remove from other EU institutions.

A final deviation from the Community method in euro area monetary policy is that the ECB epitomizes the idea of an autonomous operating agency with function-specific responsibilities rather than wide-ranging policy powers (see Chapter 4). The primary responsibility of the ECB is to define and implement euro area monetary policy (Art. 127 TFEU). It also holds and manages the official foreign reserves of the member states, promotes the smooth operation of European payment and settlement systems, and plays a central role in euro area exchange-rate policy. The ECB's overarching objective is to maintain price stability and, without prejudice to this goal, to support the general economic policies of the Community (Art. 127 TFEU). The US Federal Reserve, in contrast, is required to promote maximum employment, stable prices, and moderate long-term interest rates, a comparison which further fuels concerns over the ECB's conservatism.

The precise meaning of 'price stability' is not defined in the treaty, leaving the bank to devise and revise its own definition. In October 1998, the ECB Governing Council committed itself to pursuing a rate of inflation of below 2 per cent over the medium term. The euro area monetary authority was by no means the first central bank to adopt an inflation target but it was ahead of the curve in so doing. Whereas the Bank of England began inflation targeting proper in 1997, the Bank of Japan and the US Federal Reserve did not introduce targets until 2012. However, the ECB's definition of price stability is not as precise as that of other leading central banks, which has further fuelled concerns that the euro area monetary policy will be too conservative. The ECB Governing Council sought to address these concerns in 2004 by agreeing to pursue a rate of inflation of below *but close to* 2 per cent over the medium term, but this definition is still more open-ended than those of the Bank of England, the Bank of Japan, and the Federal Reserve, all of which target an inflation rate of precisely 2 per cent over a specific time frame. On balance, the ECB has been less conservative than economists feared—inflation, as noted earlier, was slightly above 2 per cent during EMU's first ten years—but still comparatively cautious. This can be seen, for example, in the ECB's reluctance to cut interest rates in the immediate aftermath of the global financial crisis for fear of fuelling inflationary pressures and in its reticence about introducing the OMT for similar reasons.

The ECB's preoccupation with price stability has made it wary about the pursuit of further competences for itself in the macroeconomic domain or other EU institutions more generally, but an important exception here concerns the bank's role in financial market policy (Hodson 2011). The ECB is required under the treaty to 'contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system' (Art. 127 TFEU). Although this formulation implies a supporting role for the ECB, this did not prevent some members of the Executive Board from making the case for a 'collective euro area supervisor' in the early days of EMU (e.g. Padoa-Schioppa 1999). For this reason, the ECB backed the creation of the ESRB in January 2011. This body, which is made up of national supervisors and other relevant policy-makers and headed by the ECB president, was given responsibility for safeguarding financial stability in the EU.

The ECB was more enthusiastic still about the launch of the single supervisory mechanism in 2014, which gives it significant new policy-making powers in relation to financial supervision. Under legal statutes adopted in October 2013, a purpose-built ECB Supervisory Board is empowered to authorize and de-authorize credit institutions in the euro area, thus greatly expanding the scope of the bank's activities (Regulation 1024/2013). That this role was not transferred to the ECB Governing Council can be seen, in part, as an attempt to keep the tasks of monetary policy and financial supervision separate, although this will be easier said than done. The creation of a new decision-making body within the ECB also allows non-euro area members, which are not represented on the ECB Governing Council, to participate in the single supervisory mechanism (Regulation 1024/2013, Art. 26).

## The European Stability Mechanism

The EU's emerging approach to crisis resolution offers an intriguing puzzle for this volume. In some respects, the emergency loans offered to Greece and other member states looks like a variation on the distributive mode (see Chapter 4), involving as they did fierce battles between member states over financial benefits and burdens. While the heads of state and government took a lead role in such negotiations, operational decisions over the granting of loans to member states and enforcing the conditions attached to these loans was delegated to de novo bodies. A case in point is the EFSF. One of the more peculiar exhibits in the history of EU policy-making, this fund was created in May 2010 not under the treaties but as a public limited company registered in Luxembourg with euro area members or their representatives serving as shareholders. Managed by Klaus Regling, a former Director-General for Economic and Financial Affairs at the European Commission, and staffed by 90 officials, the EFSF is overseen by a Governing Council made up of the finance ministers of euro area members with the Eurogroup president acting as chair. Representatives of the Commission and the ECB attend its meetings as observers and are involved in monitoring compliance with the conditions attached to EFSF loans, but the final say over loan disbursement rests with the EFSF Governing Council. These governance arrangements contrast with those for the EFSM, which was created under Article 122 TFEU at the same time as the EFSF and which gives the Commission a major say over the disbursement of loans to euro area members.

The reasons for creating multiple stability mechanisms at this time were threefold. First, there were concerns over the legality of both instruments therefore it made sense not to rely on either one. The EFSM relied on a controversial reading of Article 122 TFEU—which provided for financial assistance in the event of 'natural disasters and occurrences beyond [a member state's] control'—and the EFSF had no standing in EU law. Secondly, the EFSM was limited in size to €60 billion because of the maximum margin available under the EU's own resource ceiling (see Chapter 6). Thirdly, even without these financial and legal constraints, member states were reluctant to give the Commission control over a new multi-billion euro fund. Creating the EFSF provided a short-term fix.

The inauguration in October 2012 of the ESM offered a more permanent solution. The ESM is underpinned by a revision to Article 136 TFEU, which allows for the creation of a stability mechanism for the euro area, but its statutes are set out in an intergovernmental treaty that leaves key decisions in the hands of national representatives. The ESM replaced the EFSM, which concluded its operations in 2013, and it will run in parallel with the EFSF until all loans granted through this temporary stability mechanism have been repaid.

## EMU and policy coordination

Judged in terms of Chapter 4's five modes of policy-making, economic policy under EMU is an instance of policy coordination. Whereas euro area monetary policy is an exclusive competence of the Community, the treaty claims economic policy as neither an exclusive, shared, nor supporting competence of the Union (Title I TFEU). Instead, member states have agreed to coordinate their economic policies within the Union (Art. 5 TFEU). The two most important treaty instruments are the BEPGs (Art. 121 TFEU) and the excessive deficit procedure (Art. 126 TFEU). These instruments are reinforced by the SGP and, in the light of the global financial crisis, several other rules, processes, and procedures.

## The Stability and Growth Pact and the Broad Economic Policy Guidelines

Policy coordination in the EU relies on decentralized forms of decision-making in which peer pressure and consensus building between member states with little or no delegation to supranational institutions is the norm (see Chapter 4). The BEPGs are emblematic of this inasmuch as they take the form of soft law statements on the economic policies of member states and the EU designed to encourage benchmarking and the exchange of best practice. Countries that breach the guidelines or otherwise jeopardize the smooth functioning of EMU face no more than non-binding recommendations. The excessive deficit procedure prohibits member states from posting budget deficits in excess of 3 per cent of GDP and government debt in excess of 60 per cent of GDP. This is a harder form of coordination than the BEPGs because member states that break these limits face the possibility of fines, but non-binding recommendations remain the standard response to non-compliance. The timetable for moving between the excessive deficit procedure's disciplinary steps is set out in the SGP, a set of Council regulations backed by an agreement between the heads of state and government. The pact also requires member states to prepare medium-term budgetary plans that target a fiscal position of close to balance or in surplus.

The Commission plays a curtailed role in relation to policy coordination under EMU. Its primary responsibilities are to monitor member states' economic policies, draw up the first draft of the BEPGs, and sound the alarm when member states violate these guidelines or the SGP. The Commission alone can propose disciplinary measures against errant member states, but the decision to issue recommendations or impose financial penalties and fines is formally taken by Ecofin. Given the soft law character of such coordination, there are, likewise, limited opportunities for the Court of Justice of the European Union (CJEU) to intervene in this policy process. The EP is informed of key decisions taken in relation to the BEPGs and the SGP but this has traditionally been a pro forma exercise.

How can we explain member states' determination to keep economic policy on a decentralized footing in EMU? For some scholars, the explanation lies in the desire of the framers of the treaty to protect the political independence of the ECB by steering clear of a *gouvernement économique* that might seek to emasculate monetary policy (Dyson 2000). Buti *et al.* (2003: 2) emphasize sovereignty concerns, arguing that

EMU reflects the limits of what can be achieved given member states' limited desire for deeper integration in this field. On a similar note, Hix (2005: 38) argues that 'if member states were serious about policy reform in a particular area, then the classic EU method would probably be the most efficient way of achieving the policy goals'.

An alternative viewpoint is that new modes of EU governance may be suited to EMU on functional and normative grounds (Hodson and Maher 2001). One reading of the theory of optimum currency areas is that a decentralized approach to policy coordination may be desirable if it gives member states greater leeway to use national budgetary policy to adjust to country-specific shocks. Likewise, allowing member states to tailor specific reform measures to the institutional specificities of national product, labour, and capital markets may be preferable to a one-size-fits-all approach. From a normative perspective, soft law may be preferable to hard law when policy goals lack precision and when the probability of revising these objectives in the future is high. Decentralized modes of decision-making may also be preferable when traditional, centralized modes of decision-making lack legitimacy. Fiscal policy and structural reform both rest uneasily with the Community method since decisions over taxation, expenditure, and the regulation of labour markets, with their significant distributional consequences and resonance for partisan politics, go right to the heart of what democratically elected governments do.

How has EMU's experiment with new modes of EU governance fared? From a bird's eye perspective, the early years of EMU coincided with a sustained improvement in euro area public finances, as budget deficits in euro area members remained below 3 per cent of GDP. In the structural domain, member states implemented a series of measures to make employment-protection legislation less stringent, to raise average retirement ages, and to introduce greater competition in some sectors, most noticeably telecommunications (see Chapters 6, 11, and 12). These reforms contributed to rising labour force participation rates, falling unemployment, and, in some sectors, falling prices before the global financial crisis struck (ECB 2008). Progress in product and labour market reforms was matched by significant progress in financial market integration.

In spite of these achievements, serious difficulties were encountered with the implementation of the SGP and the BEPGs even after reforms to both instruments in March 2005 (see Hodson 2010). The SGP was more successful than it is generally given credit for in keeping budget deficits down during the first decade of EMU, which witnessed several breaches of the 3 per cent of GDP threshold but saw most of the member states concerned make a sustained effort to restore compliance. However, the pact plainly struggled to enforce its medium-term budgetary objectives and debt criterion and evidently failed to address inaccuracies in the reporting of public finance statistics in Greece. The BEPGs, meanwhile, encouraged a regular exchange of views between economic policy-makers at the national and EU level, but failed to apply peer pressure and did too little too late on the problem of macroeconomic imbalances (Deroose, Hodson, and Kuhlmann 2008).

## The six-pack and the fiscal compact

Whether any system of economic policy coordination would have survived the global financial crisis intact is doubtful. The shortcomings of the SGP and BEPG made reform inevitable, however, as did the member states' decision to provide emergency loans to Greece and other euro area members. That financial support and the reform of economic governance were linked in this way owed much to German Chancellor Angela Merkel, who saw closer economic policy coordination in general, and more stringent fiscal rules in particular, as a means to protect the interests of German taxpayers. A set of six legislative proposals—known as the 'six-pack' were duly put forward by the Commission in September 2010 and approved by Ecofin and the EP in September 2011. The involvement of the Parliament in this process flowed from a new provision in the TFEU, which extended the ordinary legislative procedure to rules governing multilateral surveillance (Art. 121(6) TFEU). Although negotiations went beyond this treaty provision, the EP insisted that all elements of the six-pack be jointly negotiated and so played its most significant role in shaping economic policy in EMU to date.

One of the more innovative elements of the six-pack is a new principle of reverse voting, which means that a recommendation by the Commission for corrective action under certain stages of the excessive deficit procedure would be carried unless a qualified majority of member states vote against it in Ecofin. This would make it considerably more difficult for finance ministers to overturn Commission recommendations for corrective action, as occurred in November 2003 (Heipertz and Verdun 2010), thus greatly increasing the EU executive's agenda-setting powers in relation to EU fiscal surveillance. That said, it remains to be seen just how important financial penalties will be under the six-pack. The scope for pecuniary sanctions is certainly plentiful; for the first time, member states face the possibility of fines for failing to meet the pact's medium-term budgetary objectives or for not taking sufficient steps to get government debt below 60 per cent of GDP and as soon as the 3 per cent reference value for government borrowing has been breached. For all this tough talk, however, fines were yet to be levied under the six-pack as of January 2014, which suggests that member states will continue to face no more than repeated non-binding recommendations providing they make sufficient effort to comply with Ecofin's policy prescriptions. In this sense, the six-pack remains rooted in policy coordination as a mode of EU decision-making.

The six-pack also provided for the creation of the macroeconomic imbalance procedure to prevent and, if necessary, correct macroeconomic developments that adversely affect 'the proper functioning of the economy of a member state or of economic and monetary union, or of the Union as a whole'. Imbalances are monitored via a scoreboard of indicators including growth and inflation differences, credit booms, housing bubbles, and other forms of imbalance. In the event that imbalances are deemed to be excessive, the Commission can recommend that Ecofin issues a recommendation to the member state concerned under Article 121(4) TFEU. Persistent offenders also face the possibility of financial penalties. Given the convoluted link between government policies and, say, current account deficits or house price rises, it remains to be seen whether the macroeconomic imbalance procedure will amount to anything other than a more focused but still soft version of the BEPGs.

In December 2011, a matter of days after the six-pack entered into force, EU member states started negotiations on a new Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union. Better known as the fiscal compact, this intergovernmental agreement between all EU member states with the exceptions of Croatia, the Czech Republic, and the UK (see the section 'The euro outs' later in the chapter) seeks to reinforce the six-pack by making reverse-majority voting the norm for all steps of the excessive-deficit procedure. Also significant here is member states' commitment under the fiscal compact to transpose a balanced budget rule into national law. Viewed through the lens of Europeanization, these rules can be seen as an attempt to adapt national systems of fiscal governance so as to reinforce member states' commitment to the SGP. What impact the fiscal compact will have on EMU is difficult to predict, but, as with the six-pack, its approach appears to be largely consistent with policy coordination as a mode of decision-making. The fact that the CJEU is given new enforcement powers under the fiscal compact might suggest otherwise, but the court is allowed to intervene only in cases where national fiscal rules are inadequate and only then at the instigation of another member state. Consequently, Dehousse (2012: 4) concludes that member states' 'reluctance to accept overly strict supranational checks remains as strong today as it was in the past'.

## The European semester, the two-pack, and the troika

Another innovation in EU economic policy coordination in the wake of the global financial crisis is the so-called European semester. Introduced in 2011, the European semester revises the calendar for EU economic surveillance. Under previous arrangements, Ecofin issued an opinion on member states' medium-term budgetary plans—a reporting requirement under the SGP—at a point in the year when national parliaments had typically signed off on expenditure and taxation decisions for the coming year. This made it difficult for EU policy-makers to influence national governments. Under the European semester, Ecofin has a chance to comment on member states' medium-term fiscal plans several months before national budgets have been presented to national parliaments. Critics of the European semester have expressed concern about the circumvention of democratic checks and balances over the national budgetary process (Tsoukalis 2011: 29). As with so many other aspects of EU economic policy coordination, however, recommendations issued by Ecofin under the European semester rely on peer pressure and consensus-building rather than legally binding commitments.

Building on both the European semester and the six-pack, Ecofin and the EP agreed on yet another round of reforms in March 2013. Adopted under Article 136 TFEU, which allows for closer coordination between euro area members, the so-called two-pack codifies further changes to the EU fiscal surveillance calendar and provides for enhanced surveillance of member states experiencing financial difficulties or at risk thereof. Under the regulation dealing with the first of these points, euro area members are required to submit a draft budget for the year ahead to the Commission and euro area finance ministers in October of each year with a view to adopting the final budget by December. This will require changes to national budget calendars in what can be seen as another example of the Europeanization of national fiscal policy in the light of the global financial crisis. The expectation under the European semester is that the draft budget will be consistent with each member state's obligations under the SGP and the macroeconomic imbalance procedure, but where inconsistencies are apparent the Commission can request a revised draft budget. As with the European semester, the two-pack's bark looks worse than its bite since the regulation neither specifies sanctions against member states that fail to comply with these requests nor challenges the fact that member states have first and final say over national budgets.

The second regulation in the two-pack allows the Commission to go beyond the monitoring requirements of the SGP for those member states facing, or at risk of, financial difficulties. Under this enhanced surveillance, which will be mandatory for member states in receipt of external financial assistance from the EU or elsewhere, the Commission will conduct an ongoing, intensive review of economic and financial developments. Where further action is warranted, Ecofin, acting on the basis of a Commission proposal, can recommend that the member state address financial difficulties or prepare a draft macroeconomic adjustment programme to be approved by EU finance ministers. Member states are expected to comply with this programme, but the two-pack specifies no sanctions for failing to do so other than an obligation to seek 'technical assistance' from the Commission in some cases.

For all these reforms enacted in the wake of the global financial crisis—and in spite of regular reports to the contrary—economic policy in EMU remains decentralized. Member states may have signed up to more intensive and intrusive forms of cooperation and surveillance but they retain a tight grip over the formulation and implementation of fiscal policies and structural reforms.

Whether the same can be said of member states that have turned to the EU for financial support is a matter of debate. The role of the troika in this context is especially controversial. This informal grouping of officials from the Commission, the ECB, and the IMF emerged in 2010 in response to the Greek fiscal crisis and it has since become central to the EU's crisis-management framework. Member states that seek financial support from the ESM, for example, are expected to negotiate a detailed programme of adjustment with the troika, which then visits the country on a quarterly basis to assess compliance, a positive assessment in this regard being a prerequisite for the receipt of future loan instalments.

For Scharpf (2011: 26), such arrangements are tantamount to 'a form of "receivership"' in which the EU and IMF exercise a significant degree of influence over the formulation of national economic policy. However, this interpretation overstates the troika's ability to shape national economic policies, which remain subject to the same national checks and balances albeit under economic conditions that leave limited room for manoeuvre. What a genuine EU veto would look like was suggested by German Finance Minister Wolfgang Schäuble's call in October 2012 for the creation of a 'super commissioner' with veto powers over national budgets, but this proposal enjoyed little support from other member states (Karagiannis and Guidi 2013).

That economic policy of EMU thus remains on a fundamentally decentralized footing is, in the end, not that surprising since functional and normative arguments for a more centralized approach to decision-making in the euro area remain problematic in spite of the grave crisis facing the single currency. On fiscal policy coordination, for example, the negative externalities from Greece's sovereign debt crisis may have concentrated member states' minds on the problem of fiscal spill-over, but the need for national adjustment mechanisms has not dissipated. Likewise, on structural reform the global financial crisis heightened concerns about a lack of price and wage flexibility in EMU, but differences between national product and labour markets still militate against a one-sized-fits-all approach. On normative concerns, member states are no less troubled about ceding sovereignty in a sensitive area such as macroeconomic policy. In this sense, initiatives such as the six-pack and two-pack confirm the member states' desire for the Commission to play a more assertive role in relation to peer pressure, but not in the formulation and implementation of macroeconomic policies per se.

This situation could change, of course, and the longer the euro area sovereign debt crisis drags on, the more open EU member states might become to supranational solutions. In December 2012, then European Council President Herman Van Rompuy presented a plan for a so-called 'genuine EMU' (Van Rompuy 2012). Much of this plan was taken up with the pursuit of European banking union (see Chapter 5), but a significant strengthening of EMU's fiscal dimension was also mooted. The report called for a 'temporary, targeted and flexible financial support' for structural reforms alongside 'a well-defined and limited fiscal capacity to improve the absorption of country-specific economic shocks, through an insurance system set up at the central level' (Van Rompuy 2012: 4–5). Such reforms could be a game changer for euro area governance as they would entail new distributive modes of decision-making targeted specifically at euro area members, but it remains to be seen whether Van Rompuy's plan will fly. As of January 2014, member states were mulling over ways to give financial incentives to member states for stepping up structural reforms, but they remained as wary as ever about ceding significant policy-making powers in the fiscal domain.

## EMU and intensive transgovernmentalism

Intensive transgovernmentalism, as discussed in Chapter 4, describes an approach to EU policy-making premised on the active involvement of the European Council supported by the Council of the European Union with a limited role for the Commission and the EP. Aside from the external representation of the euro area (see later in this section), this mode of governance was not especially relevant for understanding EMU's first decade, although it was prevalent in earlier periods. All of this changed with the global financial crisis, which saw the heads of state and government assume a key role not only in crisis management but in questions of euro area governance more generally (Puetter 2012).

## The Eurogroup

A key piece of EMU's governance jigsaw is the Eurogroup. This informal body, which was launched by the European Council in December 1997, brings euro area finance ministers together in advance of Ecofin to discuss the economic situation and shared policy challenges. One finance minister and one adviser from each euro area country attend the Eurogroup along with the president of the ECB and the commissioner for economic and monetary affairs. Meetings are confidential and, aside from the occasional communiqué, the Eurogroup produces few visible policy outputs. In the early years of EMU, the chair was filled by the president of Ecofin or the finance minister of the next euro area member in line for this post in cases where a non-euro area country held the EU Council presidency. In 2005, the Eurogroup appointed Jean-Claude Juncker for a two-year term of office, and he was reappointed in 2007, 2009, and 2011. In 2013 he was succeeded by Dutch Finance Minister Jeroen Dijsselbloem.

The Eurogroup's origins reflected a Franco-German compromise on the need for economic policy coordination under EMU (Pisani-Ferry 2006). In advance of EMU, France repeatedly made the case for a *gouvernement économique* to steer economic decision-making under EMU and provide a political counterweight to the ECB (Howarth 2007*b*). Germany consistently opposed such proposals for fear that they were intended as a covert attack on the independence of the bank. In a deal struck at the European Council in December 1997, member states agreed that euro area finance ministers could meet behind closed doors and without formal decision-making powers. The Eurogroup's working methods have been described by Puetter (2006) as a form of 'deliberative intergovernmentalism'. He argues that, in the absence of formal decision-making responsibilities, the Eurogroup can exchange information on shared policy challenges and reflect on national policy positions in a way that would not be possible in a busy bargaining chamber such as Ecofin.

The Eurogroup's track record as a deliberative body is mixed. On some issues, such as fiscal responses to high oil prices, euro area finance ministers have managed to pursue a relatively coherent line (Pisani-Ferry 2006). On other issues, including the external value of the euro, policy lines have been agreed but not always adhered to by euro area finance ministers (van den Noord *et al.* 2008). Furthermore, periodic public criticism of ECB monetary policy by Juncker and other euro area finance ministers during EMU's first decade shows that the Eurogroup sometimes struggled to keep discussions of the macroeconomic policy mix behind closed doors. The enlargement of the euro area may also have reduced the intimacy of the Eurogroup by adding new ministers (each with his or her own adviser) to the circle (Begg 2008).

## The euro summit

The Eurogroup has emerged as both an institutional winner and loser from the global financial crisis. All euro area finance ministers have a seat on the Board of Governors of the ESM, which has overall responsibility for deciding whether to provide financial support to member states and for assessing compliance with the conditions attached to these loans. In spite of this crucial role, the Eurogroup saw its political influence curtailed during the global financial crisis due to the emergence of euro summits. These gatherings of the heads of state and government of euro area members and the president of the Commission began on an ad hoc basis. The first such summit took place in Paris in October 2008 after French President Nicolas Sarkozy invited euro area leaders to discuss the ongoing international banking crisis. A similar convocation followed in March 2010 in an effort to reassure financial markets about Greece's fiscal situation. Euro summits became commonplace thereafter as the heads of state and government sought to get to grips with the euro area's sovereign debt crises.

In recognition of this role, euro area heads of state and government agreed in October 2011—and the fiscal compact reiterated—that euro summits would take place at least twice a year to set general guidelines on economic policy, competitiveness, and convergence for the euro area. Meetings, it was agreed, would be chaired by a president of the euro summit, to be appointed at the same time as the President of the European Council. If there was any doubt about the euro summit's seniority vis-à-vis the Eurogroup, the conclusions made clear that the president of the euro summit could invite the Eurogroup to prepare meetings of euro area heads of state and government and follow up on the results of this meeting.

This shift back to intensive transgovernmentalism under EMU is partly a pragmatic development. The involvement of the heads of state and government following the global financial crisis was inevitable given the seriousness of this situation. It was also necessary to address the initial differences between member states on sensitive issues such as the involvement of the IMF in providing financial support to Greece. That said, calls for a euro summit predate the global financial crisis. In July 2007, Nicolas Sarkozy called for a euro area summit as part of his efforts to revise negotiations over *gouvernement économique*. This proposal received short shrift from German Chancellor Angela Merkel, who, like Helmut Kohl before her, feared a plot to make the ECB more politically accountable (Hodson 2011: 47). Sarkozy bided his time, however, and the confluence of a systemic banking crisis in October 2008 and France's six-month presidency of the EU provided the perfect opportunity to gather euro area heads of state and government together.

## External representation of the euro area

Intensive transgovernmentalism can also be seen in the euro area's approach to external representation. On paper this looks like a domain in which the Community method might have found application since the treaty allows the Council, acting on the basis of a Commission recommendation, to establish a unified representation in ‘international financial institutions and conferences’ (Art. 138 TFEU). In practice, the Commission’s attempts to activate this provision have been rebuffed, with member states relying instead on ad hoc and informal measures to coordinate EU involvement in the G8, G20, IMF, and World Bank.

The involvement of the Commission, the ECB, and the Eurogroup in such coordination efforts varies, leaving the EMU’s external representation contingent on member states’ ability to speak with one voice. Scholars such as McNamara and Meunier (2002) and Cohen (2009) are sceptical about such arrangements and others such as Bini Smaghi (2006) and Ahearne and Eichengreen (2007) have called for the euro area to be given a single seat in international financial institutions and fora.

However, whether a more centralized approach to decision-making would really help here is a moot point (see Hodson 2011). Where member states agree on international macroeconomic priorities, the benefits of a unified system of external representation are not always apparent. A case in point concerns the G20, an international forum of industrialized and developing economies of which the EU is a full member, albeit with France, Germany, Italy, and the UK also in attendance. At the landmark G20 leaders’ summit on the global financial crisis in April 2009, UK Prime Minister Gordon Brown, French President Nicolas Sarkozy, and German Chancellor Angela Merkel successfully pushed a common EU line concerning tax havens without much need for the EU delegation present.

Conversely, where member states disagree, a unified system of external representation would not necessarily make much difference. One example is the IMF Executive Board, which runs the Fund on a day-to-day basis. The EU is not formally represented on this body and the representatives of individual EU member states, though they coordinate their activities through an informal body known as the EURIMF, are scattered in most cases across multi-country constituencies that include non-EU members. Although this arrangement is fragmented, there is little that a single EU constituency at the IMF could have done to expedite financial support to Greece in early 2010. EU member states were, as noted earlier, deeply divided on this issue at first and the EURIMF could present a common line within the Fund only after intensive deliberation and bargaining between EU heads of state and government. Messy though this decision-making process was, it would not have been altered by the presence of a single EU representative to the IMF.

## The euro outs

Only the UK and Denmark have formal opt-outs from Stage 3 of EMU, which they secured in negotiations over the TEU. These opt-outs are likely to remain in place unless euro membership has been approved by popular referenda. This seems like a remote prospect in the UK, which hesitated about joining the euro during the premiership of Tony Blair (1997–2007), but since then has become highly sceptical about the project. Such scepticism bordered on *Schadenfreude* during the sovereign debt crisis as evidenced by UK Foreign Secretary William Hague's description of the euro as 'a burning building with no exits' (*Financial Times*, 28 Sept. 2012). Danish voters, meanwhile, roundly rejected euro membership in a referendum in September 2000. The larger Danish political parties have traditionally been supportive of EMU, but a second referendum foreseen in 2011 never materialized and public support for the single currency in Denmark has plummeted in the light of a global financial crisis, which hit the euro area much harder than the Danish economy.

The remaining EU member states are formally required under the treaty to join the euro area if and when they meet the convergence criteria. In practice, member states retain a degree of discretion over whether and when to apply for membership of the euro area. Sweden, for example, voted against euro adoption in a referendum in September 2003 and has yet to participate in ERM II, which precludes it joining the euro. As of 2015, no member state had set a target date for joining the euro area and only Denmark is a member of ERM II (see Table 7.6). For their part, euro area policy-makers have been fairly cautious about letting new members into the euro club, especially those countries making the economically and financially turbulent transition from central planning to a market economy. Lithuania's first application for euro adoption, for example, was rejected in May 2006 after it was deemed to have missed the treaty's inflation criterion by just 0.2 per cent.

**TABLE 7.6 State of play for non-euro area members**

| | Participating in ERM II | Official target date for euro adoption | Signed the fiscal compact |
|---|---|---|---|
| Bulgaria | No | None | Yes |
| Croatia | No | None | No |
| Czech Republic | No | None | No |
| Denmark | Yes | None | Yes |
| Hungary | No | None | Yes |
| Poland | No | None | Yes |
| Romania | No | None | Yes |
| Sweden | No | None | Yes |
| UK | No | None | No |

Source: Based on ECB (2008: 84).

*Note:* Croatia had not yet joined the EU when the fiscal compact was signed in March 2012 but it can accede to this treaty at a future point.

If the global financial crisis has thus introduced new cleavages between euro ins and euro outs it also opened up divisions among the outs. This can be seen in relation to the fiscal compact, which all EU member states at the time except the Czech Republic and the UK signed. That Denmark was willing to do so in spite of its reticence about joining the euro area is curious. Beach (2013) argues that this puzzle is partly explained by Denmark and other euro outs not wanting to be left behind in a two-speed Europe in which a subset of countries can decide on EU economic policies. He also suggests that it reflected Germany's desire to involve member states with reputations for sound macroeconomic management in the fiscal compact since such countries are more likely to enforce the treaty.

In December 2011, UK Prime Minister David Cameron broke off negotiations over incorporating the fiscal compact into the EU treaties. A complex two-level game with unpredictable consequences is playing out in the UK (Hodson and Maher 2013). Some members of Cameron's Conservative Party are hoping that the European reforms needed in the light of the global financial crisis will provide an opportunity for renegotiation with the EU or perhaps even UK exit, moves that are opposed by their Liberal Democrat coalition partners. By the same token, the City of London could well be at a competitive disadvantage if closer cooperation between a subset of EU member states on economic matters has implications for single market matters. Having walked away from the fiscal compact, David Cameron pledged in January 2013 to renegotiate the UK's membership of the EU, if leader of a majority Conservative government, and to hold an in–out referendum on UK membership by 2017. Whether this is a ploy to extract concessions from France and Germany or rather a step closer towards UK withdrawal remains to be seen.

## Conclusion

The traditional Community method has waned as EU member states have sought alternatives to centralized and hierarchical modes of policy-making. Nowhere is this more evident than in relation to EMU. Monetary policy and financial supervision rely on the delegation of key decision-making powers not to the Commission but to a new kind of Community body: the ECB. Economic policy, in contrast, relies on a combination of policy coordination for fiscal policy and structural reforms and intensive transgovernmentalism when it comes to external representation and the involvement of the heads of state and government.

EMU's first decade delivered on its promise of price stability. The member states, however, fell short in their commitment to fiscal discipline and failed to address the build-up of macroeconomic imbalances. These shortcomings amplified the effects of the global financial crisis, which sowed the seeds for banking turmoil, a steep recession, sovereign debt difficulties, and brought the single currency to the brink of collapse. EU policy-makers responded to this crisis with a wave of new procedures, rules, and processes governing economic policy and through ongoing negotiations over European banking union. Significant though these changes are, they have not relied on the Community method. EMU thus remains a high-stakes experiment in new modes of EU policy-making.

## NOTES

1 Thanks to Mark Pollack, Christine Reh, Helen Wallace, and Alasdair Young for helpful comments on an earlier version of this chapter. The usual disclaimer applies.

2 For a timeline of the EU's response to the global financial crisis, see: *http://ec.europa.eu/economy_finance/crisis/index_en.htm*.

## FURTHER READING

For an introduction to the economics of EMU, see De Grauwe (2012). Dyson and Featherstone (1999), Moravcsik (1998), and McNamara (1998) explore the political dynamics underpinning EMU's creation and James (2012) offers a historical perspective on the evolution of EMU. Schelkle (2006) revisits some of the seminal contributions to the debate on euro area governance, Heipertz and Verdun (2010) provide an in-depth treatment of the SGP, and Hancké (2013) looks at the neglected issue of wage-setting under EMU. Hodson (2011) takes stock of EMU's experiment in new modes of EU policy-making from the launch of the euro to the sovereign debt crises.

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