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The Contribution of 14 European Think Tanks to the Spanish, Belgian and Hungarian Trio Presidency of the European Union

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ECONOMIC GOVERNANCE

Governing the Eurozone out of the Crisis

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Specific challenges for the Trio Presidency

The recent financial and economic crisis has posed the most serious challenge to the European Monetary Union (EMU) since it was created over ten years ago. At the same time, the EMU has proven a safe haven for its participating countries, having avoided currency turbulences and severe speculation against single member countries. It has formed a core of stability in the single market. The attractiveness of the euro has consequently risen considerably in the eyes of those member states which are not (yet) part of the single currency, notably in Central and Eastern Europe, and which were on average more strongly hit by the crisis than the EMU members.

At the end of 2009, economic indicators pointed to a possible economic recovery both in the EU and the US. But several risks remain and pose specific challenges to the current Trio Presidency:

- The situation of the banks in the EMU may still hamper economic recovery: a spill-back of corporate insolvencies into the banking sector would put new strains on Europe's banks and would increase the already very strong prudence in the financial system. Hence, the allocation of credit to companies may continue to be insufficient. This may cause short-term refinancing problems with a danger of provoking insolvencies and a reduction of investment – e.g. in research and development – which could, in the medium and long-term, negatively impact the competitiveness of the EU corporate sector.
- The political and social effects of the financial and economic instabilities will take the crisis into its third phase. Domestic developments such as rising unemployment (in some cases up to 15 to 20%, 10% on average for the EU) can make certain governments less cooperative and more protectionist. The context for pushing structural reforms and measures to complete the single market (e.g. in the financial and services sector) has thus deteriorated.
- The continued trend of economic divergence in the EMU (due to different degrees of competitiveness) has been aggravated by the crisis, which has hit less competitive

economies harder than those with a high degree of competitiveness. This results in continued economic and political tensions, manifest policy divergence and a politically and economically more complex context for the ECB to act in.
- The deterioration of public finances risks making public finances in some member states unsustainable (possibly even provoking a sovereign default) and could undermine the existing framework of fiscal surveillance in the EMU.

The current Trio Presidency comes in at a time when the adjustment process to the economic and financial crisis is reaching its potential. But all this must be managed in a context where, at the domestic level, the willingness to accept structural reforms, budgetary adaptations and cooperation within the EU will be somewhat low; and where, at the European level, the governance institutions and procedures of the EMU will continue to experience a crucial stress test. However, the way the EMU manages its adaptation to the economic and financial shock in the next two years will decide its medium-term performance in a world economy characterised by shifting power relationships, with emerging markets such as China recovering from the crisis at a quicker pace than Europe or the US.

Current status

In order to tackle the challenges of the crisis, policy change and institutional adaptation will be required, at the European, national and international levels. On the policy side, the economic and financial crisis has already caused certain dynamics:
- As early as 2007, the ECB reacted swiftly to the crisis by introducing large amounts of liquidity into the markets. The expansionary monetary policy persists to date.
- In the EMU member states, budgetary policies have shifted towards expansive growth stimulation. Meanwhile, consolidation and the long-term sustainability of public finances seem to have lost importance to most governments.
- Bank rescue packages and subsidies for key industries have decisively expanded the role of the state in most member states' economies. The European Commission has at least temporarily relaxed the application of EU competition policy.
- Rhetoric and policies in many member states have changed towards a more protectionist stance. In some cases, national announcements or even policy measures have been in contradiction with the principles of the single market.
- The financial crisis has revealed serious inconsistencies in the existing financial-market regulation in the EU, for instance in the field of deposit guarantees or mortgage credit. As insufficient standards in single member states are perceived as having EU-wide implications, the issue of financial-market regulation has made a strong return to the EU policy agenda – which, since the arrival of Charles McCreevy as Commissioner for the single market in 2004, had been characterised by a more market-driven approach with less appetite for EU regulation.

The management of the financial crisis has also caused certain dynamics on the institutional side:

- The first eurozone summit: in October 2008, the French EU Presidency brought together for the first time the heads of state and government of the EMU (together with the British Prime Minister) to discuss support measures for the European banking sector. This institutional innovation so far has had no follow-up, but it is a format which could be used by the current Trio to discuss the most important EMU issues (see below).
- Strengthened European financial supervision: the Ecofin of 9 June 2009 and December 2009 and the European Council of 18/19 June 2009 decided to put in place new structures for a more integrated macro- and micro-prudential oversight , following the recommendations of the de Larosière Group.
- Winners and losers in terms of credibility: while the European Central Bank has been able to strengthen its position and credibility due to its swift reaction to the crisis, the European Commission has lost authority due to its failure to assume leadership in the crisis management process, which was partly a result of the reluctance of the EU member states. It is a major challenge for the new Commission to re-establish its authority in order successfully to ensure the application and (in particular) the further development of the mechanisms for fiscal and economic policy coordination in the EMU.
- A new global governance debate: on the global scale, questions of economic governance have moved to the top of the agenda as the causes of and remedies to the current crisis can only be tackled at the global level. The creation of the G20, a move which takes into account the need to involve the emerging economies more strongly, is the most visible development. Yet the EU and the eurozone have so far come up neither with a consistent position on the future shape of global governance institutions in the field of economics and finance, nor with a proposal for how the EU and the EMU as entities will meaningfully engage in global economic governance.

Proposals for the Trio

Out of the three Trio partners, only Spain and Belgium are members of the European Monetary Union. Given the challenges outlined above, both should put EMU and EU economic governance issues high on their agenda. However, Spain in particular is in a difficult situation with regard to its economic outlook, its public finances and soaring unemployment rates. Belgium, on the other hand, does not have a particularly strong political role in the EMU. Both should hence seek close cooperation with partners such as other large EMU member states – in particular Germany and France – the European Commission, the European Parliament and in particular the Eurogroup, in order to advance the debate on the economic policy coordination framework in the EU.

One of the top priorities in 2010/2011 will be the management of exit strategies. Together with the European Commission and the ECB, the EU Presidency should take a strong role in the debate on when to leave the crisis-management mode (characterised by an expansion of central bank liquidity, massive public deficits and state interventionism). Interest-rate increases, budgetary adjustment and a withdrawal of government guarantees for the financial sector have to be coordinated in order to avoid a new economic downturn if uncoordinated fiscal and monetary restraint cause domestic demand slumps and weigh on corporate activities through higher interest rates. It is important to have the highest possible degree of confidential exchange between the member states and the ECB – for instance within the Eurogroup – and at the member state level to have close coordination between the two largest eurozone economies, Germany and France (at present these countries seem to be pursuing different fiscal exit strategies). The resulting domestic developments may increase internal tensions in the EMU.

The re-launch of the Lisbon Strategy (2000-2010) under the heading 'EU-2020' is on the agenda of the Informal European Council on February 11th and of the Spring European Council, under the Spanish EU Presidency. While the Lisbon Agenda has shown the limits of a ten-year project in a crisis context, this strategy should be structured in two sections of five years each, with a review of the achievements and the global context in 2015 in order to respond to the rapidly evolving European and global situation. The current Trio Presidency should, firstly, state clear political priorities for the new European growth strategy – such as a return to sustainable growth and employment, a decisive improvement of the EU's competitiveness (given rapid development in other world regions), the guarantee of the long-term sustainability of public finances and social systems and the objective of convergence within the eurozone. The debate on EU-2020 should be closely linked to the debate on the future of the EU budget, which risks being blocked by the old conflicts already apparent in the previous budgetary negotiations (see Peter Becker's contribution in this volume). Given the fact that the eurozone is technically one economy with a single monetary policy, specific attention should be paid to EMU-wide development needs. This includes both micro-economic aspects (such as the particularly strong need for structural reforms in some EMU member states, which no longer have the exchange rate as an adjustment mechanism) as well as macro-economic considerations (such as the discussion of the need for fiscal stabilisation mechanisms at the EMU level).

In close connection with the new European Growth Strategy, the economic policy coordination framework in the EU, and most importantly in the EMU, needs to be improved. The economic and financial crisis has revealed the deficiencies of supervision, both of the financial markets and the member states' economic and fiscal politcy. The future of the Stability and Growth Pact is not clear, given the fact that most EMU member states are in breach of the upper limits. There is no clear commitment in most member states to correct this situation once the exceptional circumstances of the crisis have ceased to exist. Debates on the reform of the coordination framework should logically be linked to the objectives of the future European growth strategy.

- The improved coordination framework should pay more attention to economic divergence resulting from discrepancies in the development of national and regional competitiveness. The surveillance framework, which so far has put the strongest focus on public finances, should henceforth be expanded to further indicators such as private debt, external balances and other indicators of the relative competitive position of a member state, leading to a more encompassing framework of macro-economic surveillance. This discussion should be directly linked to the debate on the future of the Stability Pact in order to devise a coherent framework. Within the EU economic policy framework, the EMU should receive particular attention.
- With regard to developments that undermine macro-economic stability, recommendations to single member states are of particular importance. Past experience (for instance with the recommendations to Ireland under the framework of the Broad Economic Policy Guidelines, BEPG, in 2001 which caused a huge national uproar as Ireland was asked to pursue more restrictive fiscal policies for macro-economic reasons – in times when it was running a budgetary surplus) have shown how difficult it is to recommend policy changes to single EU member states. Since this experience of 2001, the willingness of the European Commission (and the member states which review the BEPG before publication) to request policy change has diminished.
  Fresh political will to improve economic policy coordination is thus needed, which implies both a pro-active European Commission and a strong Eurogroup chair (to be chosen in 2010 for two and a half years) as well as a highly constructive role for the Ecofin Presidency (assured by the members of the Trio Presidency). This is a prerequisite for soft coordination to work (which will remain the dominant governance mechanism as there is no majority among the EU member states to transfer sovereignty in the field of economic or fiscal policy to the EMU or EU level).
- In order to broaden the trans-European element in the debate on economic policy in the EU and EMU, the European Parliament should be involved as much as possible and despite the fact that it has no formal competencies in this field. The monetary dialogue of the EP Committee for Monetary and Financial Affairs with the ECB President and the informal exchange with the Eurogroup President should therefore be maintained and even strengthened. The new special Committee dealing with the Economic and Financial crisis should equally be nurtured in order to become part of the European economic policy debate. Dialogue with national MPs should be increased, involving the key European policy-makers in the EMU, the ECB President, the Eurogroup President and the European Commissioner.

In general, in managing the EU and EMU economic governance agenda, the Trio Presidency must pay close attention to all relevant players. This is particularly true given that the governance structure of the EMU is still somewhat informal, is under constant evolution and must be reshaped in response to the changes the Lisbon Treaty brings about for the EU in general. A close and constructive working relationship with the new Commission is key – most importantly with its President (who must define the overall work programme of the Commission and re-establish it as a relevant actor in the EU's response to the crisis), with the Commissioner for Economic and Financial Affairs, with the Commissioner for the Single Market and those for related policy areas. Furthermore, the involvement of the EP in the debate on the future of economic policy in the EMU and EU is important, most notably because it is a key player in the ambitious legislative agenda for financial-market regulation which the Commission will start to table from 2010.

Strong political commitment and a strengthening of the authority of all actors involved in economic-policy coordination would help the EMU and the EU to act more swiftly in a new round of the crisis. The EU under the Trio must prepare for new cases of crisis management which may be more complex to solve than many of the incidents since 2007. Today, for instance, a case of sovereign default within the EU cannot be excluded (for which the instruments currently applied to the comparable cases of Hungary, Romania and Latvia are not applicable, since the Balance of Payment Loans according to Art. 119 can only be granted to non-EMU-member states). Likewise, a possible dollar crisis (and hence a strong and uncontrolled appreciation of the euro) is a scenario which might hit the EMU under the EU Trio Presidency. Such incidents may require the convening of a new eurozone summit.