CAHIER COMTE BOËL

n° 11

European Economic Governance revisited

LIGUE EUROPEENNE DE COOPERATION ECONOMIQUE
EUROPEAN LEAGUE FOR ECONOMIC COOPERATION

FOREWORD

In the past, ELEC has closely monitored the creation and implementation of the Economic and Monetary Union. It has published two "Cahier Comte Boël" (n° 8 in 2000 and n° 10 in 2002) welcoming the process of setting up the euro and its accompanying framework, as well as expressing its own recommendations in this respect.

The euro has now been in place for five years. While the monetary side of EMU has been working satisfactorily – indeed, it has been a blessing of stability, when compared with the turbulences which the observed shocks, during the period, would have entailed under the previous monetary framework –, the economic performance of the euro area has been disappointing in several respects.

This new "Cahier Boël" argues that the experience of the last five years, as well as the added challenge of the enlargement of the European Union, call for a substantial strengthening of the economic governance of the EMU, as well as of the European Union as a whole. In doing so, ELEC joins the chorus of EMU watchers sending similar messages.

The "Cahier Boël" has been written under the joint sponsorship of the Economic and Social Commission and the Monetary Panel of ELEC. The chairmen of both groups, respectively Philippe Jurgensen and Jean-Jacques Rey, wish to thank the members of the task force that was specially appointed to draft the Cahier, namely Werner Becker, Jean-Victor Louis, Ralph Odendall and Robert Raymond. Useful comments or complements were also provided by others, more particularly Bernard Delbecque, Paul Goldschmidt, Jean-Jacques Schul and Roland Tavitian.

While the individual members of the task force and, indeed, of ELEC, are not committed to support every single point made in this "Cahier Boël", they collectively endorse its basic message as reflecting a consensus among them.

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Outline

Summary and Conclusions

1. The single market and the Economic and Monetary Union (EMU) are both core elements of the European Union. Both involve the elimination of barriers of various kinds between the participating countries and are buttressed by public policies geared to their operational efficiency and the safeguard of the common interest. In fact, EMU adds to the policy requirements of the single market to ensure the stability and the credibility of the single currency, the euro.

2. Not all members of the European Union (EU) have adopted the euro, and the forthcoming enlargement of the EU will widen the difference between the territory of the EU and that of the euro area, at least for some time. While it is important to strive for the full geographical coincidence of both territories, and, in the meantime, to avoid a needless fragmentation of public responsibilities within the EU, the single currency calls for specific provisions to ensure its appropriate management and policy environment.

3. While the monetary component of EMU is a genuine union, its economic component is not. The economic union involves single market related provisions, ensuring the free circulation of persons, goods, services and capital, as well as a unified commercial policy and a centralised competition policy designed to safeguard fair trading practices. It also involves provisions for the coordination of macro-economic policies. These policies – other than monetary – remain a national responsibility, because the main instruments, such as taxes, public expenditure and many regulations remain national: nevertheless, they are to be regarded as a matter of common concern, and are therefore subject to various provisions for coordination aiming at promoting the objectives of the Union, as defined in the Treaty. The common concern is not further defined, but is reflected in the provisions for solidarity and social cohesion among EU countries and encapsulates the presumption that economic policy coordination yields better economic results than an uncoordinated approach. The combination of provisions which shape the decision-making process in this respect is called the economic governance.

4. After five years of experience with the euro, the economic governance needed for a proper functioning of EMU has clearly proved to be sub-optimal. Not only has the economic performance of the euro area been disappointing – there are several explanations for this – but the co-ordination process has failed to work as initially intended, and to produce acceptable outcomes. This situation is harmful and possibly dangerous. Public opinion does not perceive the benefits of economic union and underestimates its achievements. The European Central Bank is often treated as the scapegoat for disappointing economic results. EMU is virtually ignored in international fora, where its proper authority is denied by its own members, because of inappropriate representation.

5. The European League for Economic Cooperation (ELEC) is hoisting an alarm signal with regard to the present weakness of the economic governance of EMU. The issue was also a major theme of the European Convention. It has been on the agenda of the European Parliament and the European Economic and Social Committee. The European Commission repeatedly stressed the need for stronger provisions on economic governance. In publishing this Cahier, ELEC expresses its concern along the same lines and makes its own suggestions for a stronger and more consistent framework of governance. It expresses the hope that they will be picked up, if not by the present Intergovernmental Conference, at least by subsequent attempts to amend the Treaty. Not all suggestions, in any case, imply Treaty changes.

6. Macro-economic policy essentially involves monetary policy and fiscal policy, the combination of which is usually referred to as the "policy mix". It is generally recognised that the policy mix is not an instrument which allows fine tuning of the economy in the short term. Furthermore, it would not be in line with the mandate and the independence of the European Central Bank to subordinate its actions to prior coordination with the ministers of finance.

Yet, at any time, the euro area is de facto subjected to a form of policy mix which deserves critical analysis, and, if clearly inappropriate, corrective action. The provisions for cross-consultation between the monetary and political authorities should be seen to work out efficiently and, if necessary, should be further strengthened.

7. Monetary policy decisions are centralised, under the control of the European Central Bank (ECB). The provisions for monetary governance are adequate for the purpose of conducting monetary policy. The decisions themselves should be carefully monitored and, when appropriate, criticised, but the monetary governance does provide for the public accountability of the ECB. However, it is undesirable that this framework, adequate as it may now appear, should remain permanently enshrined in a Treaty or Treaty-like instruments, subjecting any change to the veto of any EU member country. Except for the priority attached to price stability, it would be desirable that the procedure for amending the Treaty provisions for monetary governance be exempted from the requirement of unanimity in the Council.

8. Fiscal policy raises a major problem to the extent that the fiscal discipline is in danger of evolving from a major success to a disastrous relapse into benign neglect. The suspension of the excessive deficit procedure for France and Germany in November 2003 should not be seen as an argument for relaxing the provisions of the Stability and Growth Pact (SGP) – it would rather be an argument to the contrary. Nevertheless, rules should be reviewed from time to time and in this case, it would be desirable for the economic union to move from a framework of "may or may not" type of provisions for individual countries to a more mature collective management of the fiscal stance in the euro area.

In order to start moving in that direction, the fiscal discipline should be revised to include two layers of provisions. The first layer would constrain the margin of manoeuvre of the national authorities, much as at present, except for two major changes. Firstly, the focus should no longer be on the nominal deficit, but on the cyclically-adjusted balance, to be maintained around zero, ensuring symmetry in the need to build up nominal surpluses and to tolerate nominal deficits, depending on the point reached in the economic cycle. Secondly, a breach of the commitment should trigger an ad hoc activation of the second layer of provisions instead of financial sanctions. This second layer would consist in a sequence of steps, starting with a much tighter multilateral surveillance than hitherto, with quarterly and ad hoc assessments focusing both on the aggregate and on the individual fiscal stances and taking account of a set of economic factors such as the debt ratios, the current balances, etc... If needed, the Commission would issue recommendations to one, several or all countries, which the Council would adopt or reject, and these recommendations could either reinforce or overrule the first layer commitments. The breach of such recommendations, once established by the Commission, would, after some delay, entail the temporary but renewable suspension of the voting rights of the infringing member under all the provisions relating to fiscal policy. Admittedly, extensive amendments would need to be brought to the Treaty provisions to implement such a scheme. Moreover, its implications for the fiscal discipline applicable to non-EMU countries, and to the fiscal convergence criterion, would deserve careful attention.

9. Structural policies and reforms encompass many policy areas falling under different degrees of EU involvement and competence. In some areas, closely related to single market issues, EU legislation is the driving force behind convergence or harmonisation, usually at EU level rather than for the euro area alone. In other fields, where the principle of subsidiarity leans towards decentralisation, the common interest is nevertheless captured, either under the Broad Economic Policy Guidelines, or under the open method of coordination, or both. Soft governance, as this process is sometimes referred to, should be commended insofar as it brings the European dimension to bear on national initiatives. Great attention should be devoted, however, to the risk that soft governance might substitute for stronger EU action where the Treaty provides for it.

10. Structural policies and reforms are usually seen as a weak point in the development of the European growth potential. Member States should be closely assisted and monitored by the institutions of the European Union in meeting the political challenge of bringing about the needed action. Where reforms are effectively carried out, care should be taken that they are not at odds with the prescriptions or commitments under the Broad Economic Policy Guidelines and that they do not entail negative spill-over effects in other Member States.

11. Taxation policy and the level and composition of public expenditure are strategic components of structural policies, as well as sensitive areas of national sovereignty. Fiscal harmonisation should be promoted whenever fair trade is at stake within the single market. The European Initiative for Growth in 2003 should not be regarded as a macroeconomic tool to boost short-term demand nor as a first candidate for spending cuts in times of cyclical boom, but as a major contribution to promote a more growth-friendly structural package of public expenditure throughout the EU.

12. Strengthening the economic governance in the euro area and in the European Union implies corresponding institutional adjustments. The Draft Constitutional Treaty adopted by the European Convention makes some progress in that direction, albeit rather modest. Further steps are required, such as the following:

- the European Commission should have broad powers of initiative and implementation, as the guardian of the common interest;
- there is a need to upgrade the Eurogroup into a restricted Council endowed with the ability to adopt decisions on the proposal of the Commission, by qualified majority voting, when they apply specifically to the euro area;
- the European Parliament should be closely associated with the strengthening of the economic governance; in particular, it should be involved in the process of drawing up the Broad Economic Policy Guidelines;
- ways should be explored to involve the national administrations competent for economic policy, together with the relevant services of the European Commission, in a network of European-wide loyalty, mandated to follow the preparation, implementation and evaluation of national policies; this European upgrade of national administrations would begin to mirror the way national central banks report both to the European Central Bank and to their national constituencies.

13. The external representation of EMU and the EU in economic and monetary affairs does not mirror the degree of integration brought about by the single market and the single currency, except as far as commercial policy and competition policy are concerned. The economic governance has failed to adjust to the new reality, entailing a considerable loss of potential influence for Europe in the international area.

The pragmatic approach followed until now is arguably justified in the case of the IMF by the fact that this institution is country-based, not currency-based, by the geographical discrepancy between the EU and EMU and the evolving geometry of both, and by the asymmetry between monetary policy provisions of EMU on the one hand and fiscal as well as economic policy provisions on the other hand. None of these obstacles, however, should stand in the way of improving on the present situation, nor should they allow the Member States to undo the solidarity achieved within the Union or to escape the discipline imposed by the Union. The euro area should speak with one voice and a single representation should be organised where appropriate, along the lines prevailing in the area of trade negotiations.

14. The proposals made above assume a constant environment concerning the distribution of competencies, fiscal receipts and public expenditure between the Member States and the Union. Over time, the experience with such an environment, as well as with the process of further globalisation, may lead Member States to observe that their own ability to influence the economy through nationally-controlled instruments is eroding to such an extent that a further major transfer of responsibilities to the Union must be contemplated in conformity with the principle of subsidiarity and its two-way flexibility. The debate just starting about the financial prospects of the Union for the period 2007 – 2013 shows that the time for such a quantum jump may not yet be ripe. However, the calls for a stronger economic policy involvement from the centre, including at the operational level, are gaining ground. The implications for the economic governance of both the EU and EMU, if still distinct, will be considerable.

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Introduction

The launch of the euro in 1999 provided a new pattern of macroeconomic policies in EMU countries with a centralised monetary policy and decentralised fiscal policies which are subject to the coordination rules of the Stability and Growth Pact (SGP). Whereas monetary union has functioned properly from the beginning, fiscal coordination remains vague and imperfect and the SGP as applied has failed to guarantee fiscal discipline. As far as structural policies are concerned, Member States have tended to approve ambitious programmes of reform at the European level, but abstained from or delayed their implementation at home, or else, adopted reforms on their own, without giving priority to the need to establish a level playing field on which businesses and consumers, investors and borrowers could compete freely.

Experience reveals the weakness of economic governance in a number of domains. Governance is a combination of transparency and pedagogy on the one hand, on the other hand of the ability to design a medium-term strategy, to implement it and to react to unforeseen events. Within the EU, this is made more complex by the difference of perimeter between the Union and the euro area, the latter requiring a tighter coordination in various fields.

Progress to improve governance should take into account the following factors.

Firstly, there are spill-over effects of economic policy decisions of one country on other EU Member States. According to the EC Treaty, member countries "regard their economic policies as a matter of common concern" and are "to coordinate economic policies within the Council". The framework for coordination within the EU is staked out in the annually agreed "Broad Economic Policy Guidelines" (BEPG, see Annex I - 1). Their goal is to ensure stability-oriented macroeconomic policies and structural reforms in order to promote growth and employment. However, they only have the nature of recommendations.

Secondly, whereas the responsibility of monetary policy has been assigned to the ECB with a clear mandate, by a Treaty ratified in all member countries, economic policies lack public accountability at a European level. Although public opinion does not identify all the detrimental spill-over effects of national policies, there is a growing feeling that the weakness of economic governance of the EU or euro area is a problem that should be addressed.

Thirdly, the enlargement of the European Union by 10 to 25 Member States as of May 2004 calls for an adaptation of the community decision-making structures in order to ensure the EU's ability to decide and to act in the future.

Fourthly, it has to be recognised that the UK and Sweden as non-EMU Member States have achieved better economic results in terms of growth and employment since 1999 than the euro area. This is not only due to a lack of structural reforms in EMU member countries but also a lack of policy coordination within the euro area.

Fifthly, the very fact that three out of 15 EU Member States are unwilling to join EMU implies that these countries still have room for an improvement of the efficiency of their economies by adopting the euro some day in the future. Many of the ten countries which join the EU in May 2004 seem to wish to adopt the euro as their currency as soon as they can. Obviously they would like to benefit from the elimination of exchange rate risks and from lower interest rates.

This publication starts with an analysis of the causes of dissatisfaction with the state and experience of economic governance in the EU (Chapter 1), considers the ways and means of improving the management of macroeconomic policies (Chapter 2), examines how to better deal with structural reforms in areas related to the economy (Chapter 3), makes some suggestions regarding the institutional implications of a stronger economic governance (Chapter 4), and finally mentions problems concerning the external representation of the EU or the euro area on these matters (Chapter 5). The purpose is not to assess the appropriateness of the current level of key economic variables such as interest rates, budget deficits, the exchange rate of the euro, growth, etc... but to submit proposals aiming at the improvement of governance. A lot can be done in the framework of the Treaty, by a more ambitious use of its provisions, although some modifications of the Treaty are called for and can be achieved on the occasion of the adoption of the Constitutional Treaty or of future revisions.

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CHAPTER 1
THE NEED FOR BETTER ECONOMIC GOVERNANCE

1.1. The present set-up of policies

The Economic and Monetary Union (EMU) is a core element of the EU's fabric of economic governance. It involves a single monetary policy, carried out by the European Central Bank (ECB) and the national central banks of the twelve participating countries (the whole being called the "Eurosystem") as well as a combination of economic policies remaining under control of national authorities, but linked by a set of provisions for coordination.

For some, this state of business is justified on the grounds that monetary policies rely on a limited set of tools, while economic policies are a complex set of goals, instruments and procedures best decided at national level to take into account the persisting diversity among national markets, preferences and traditions. For others, EMU means a parallel between economic and monetary governance in order to tap the full potential of the single market. Possibly it also implies political integration. However, some degree of intricacy arises from the fact that the single market encompasses all EU countries, i.e. also those not included in the euro area.

A high degree of integration is already observed in some specific areas of economic policy. Indeed, some instruments of economic policy no longer belong to national governments, and are genuinely supranational at the EU level. Commercial policy is an example, competition policy is another. Some community-wide financial instruments pursue economic and social objectives, however limited they are. By contrast, regulations, taxation and public spending are the main tools of economic policy at the national level at which economic policy is still felt to be politically relevant. This applies in particular to structural reforms, even though they may compromise the establishment of a level playing field.

Today, coherence between decentralised economic policies and the single monetary policy, as well as the mandated pursuit of the common concern [1], are dependent on a process of coordination that bites with varying impact. It may involve discussions and consultations resulting in the adoption of common or concerted economic policy strategies, defined in non-binding terms as in the case of BEPG which are applied to all EU member countries. It may get some more teeth when the open method of coordination (OMC) applies, leading to a degree of comparative rating of national achievements. The OMC has been modelled on the provisions for economic policy coordination and multilateral surveillance and, as far as employment is concerned, it is a complement to the process of article 99 of the EC Treaty. In its strongest form, coordination relies on specific commitments limiting the margin of manoeuvre of national authorities, as provided for by article 104 EC Treaty concerning the SGP for EMU Member States regarding fiscal discipline.

1.2. What does experience teach us?

In theory, and in the official discourse, this set-up should already work, which means that the single market, the single currency and existing arrangements for policy making are suitable for ensuring non-inflationary growth. As they joined EMU, twelve out of fifteen EU member countries expected a major improvement of the efficiency of their economies, by eliminating intra-zone exchange rate crises and risks, ensuring stable prices, smoothing the impact of external shocks, and promoting the convergence of macro-economic variables. The standard of living of their peoples would rise.

Experience shows that these promises are yet to be fulfilled.

Although it is premature to draw definite conclusions about the comparative economic performance of EMU, the fact is that it is disappointing so far. Instead of the expected rapid growth that should have accompanied the elimination of the last major obstacle to a full single market, economic growth has been mediocre [2]. For EMU as a whole, growth has tended to lag behind that of the USA, with the gap

[1] Common concern is based on solidarity and economic cohesion within the EU. Respecting common concern applies to circumstances in which coordination will lead to better economic results than an uncoordinated approach.
[2] See in particular www.promeuro.org Nouveau programme éducatif, illustration 7^{e}.

growing after 2002, and it remains below the average of non-EMU EU Member States. Unemployment of most EMU Member States stays at unacceptable high levels and far above that of other main industrialised economies. The expected decoupling of Europe's economic performance from that of the USA has not materialised.

The weak economic performance of EMU cannot be sufficiently explained by the slowdown of the world economy. There are also "domestic causes" in Europe. For instance, inflexibility of labour markets is often blamed for the mediocre economic performance. Distortions and administrative obstacles due to national preferences are a serious hurdle to free circulation of persons, goods and capital in the single market and thus to growth. There is no lack of diagnosis or policy recommendations to deal with the problem, but Europe seems unable to generate the impulse and confidence which would allow it to draw the full benefit of an improved policy environment. This is precisely the point at which it is argued that better economic governance could lead to a better growth performance.

1.3. Deficits in policy coordination

There is reason to worry that the economic leg of EMU is not delivering its anticipated share of the "common concern" in terms of stimuli to growth, and is thus damaging the consistency and credibility of the undertaking. The current arrangements simply do not perform as they were intended to, to the point that their working casts a shadow on the ability of EMU to serve optimally the interests of the euro area, or at least to be perceived as serving these interests. Three points, in particular, highlight this.

Firstly, there is no public perception that national economic policies proceed along the path of a coordinated design. Where Europe bites on national decisions, it does so by prohibiting recourse to some measures, thereby restricting the margin of manoeuvre of the national authorities. While open to discussion, the SGP suffers from the absence of understanding in the public at large and of loyal support from "electorally" sensitive authorities. Where reforms are being implemented in conformity with the "Broad Economic Policy Guidelines", their European origin is pinpointed whenever they hurt, while national authorities take the credit for enacting the successful ones.

Secondly, when policies fail to produce the desired impact within the expected time frame, the temptation is to put the blame elsewhere. As a result, the ECB and its monetary policy become easily designated scapegoats. Surely, ECB policies should not be immune from criticisms but when these emanate from governments of EMU countries, they ought to be expressed in the regular dialogue between the ECOFIN Council and the ECB rather than through public media. Ping-pong statements between the ECB executives and national authorities ultimately relay negative messages on acceptance of EMU in the general public. However, it is unlikely that a constructive dialogue leading to a suitable level of cooperation will develop as long as the economic governance of EMU remains as weak as it is.

Thirdly, the failure to achieve a set of cohesive economic policies is repeatedly highlighted when these policies come to be discussed in international fora. When the representatives of EU institutions participate, they are treated as subordinate to the representatives of the Member States, who inevitably argue for their own constituencies rather than for the collective interests of the EU or the euro area. The rest of the world does not perceive any ability of the EU as a whole, let alone EMU, to formulate and implement a coordinated set of policies. In some economic areas, commentators refer to Europe as an aggregate for the sake of simplicity rather than as a reflection of a mature Europe-wide coordinated policy.

So, the question is: can the model be fixed to work efficiently as intended, lending full credibility to EMU in spite of the multiplicity of economic deciders?

We cannot escape, in the near future, to work with essentially decentralised instruments and responsibilities in the field of economic and fiscal policies, and we should therefore seek ways to strengthen the processes whereby policies are coordinated and loyalty to EMU enhanced. We should also recognise that globalisation leads inexorably to the erosion of national margins of manoeuvre, and that, over time, the very safeguard of the European social model, built on a strong economy, calls for *an upgraded* economic policy capacity in Europe, going beyond the modest proposals put forward in this "Cahier" (see Annex II - 2.).

CHAPTER 2
MACROECONOMIC POLICIES – DIRECTION FOR CHANGE

2.1. The objectives

In this chapter, ways are explored to enhance the credibility of EMU by giving more flesh to the requirement that national economic policies be conducted as a matter of common interest. The focus is on the issue of macroeconomic stabilisation of cyclical movements in EMU as well as the need and scope for change in monetary and fiscal policies. It is recognised that the European Convention addressed this issue but failed to reach significant results. An opportunity may thus have been squandered, but the history of Europe is one of missed and regained opportunities. This paper does not regard the proposed provisions of the Constitutional Treaty as a ceiling to its ambitions, but will argue that much can be achieved to remedy some of the deficiencies by improving current practices, even within the existing Treaty provisions.

2.2. A contra-cyclical policy for EMU?

There is, prima facie, no room for any discretionary contra-cyclical macroeconomic management in EMU. The economic debate goes on to question the relevance of any discretionary contra-cyclical policy, for any country or group of countries, beyond the expected impact of the fiscal automatic stabilisers. The inherent limitations of the instruments, when they are available at all, severely constrain the scope for fine-tuning the economy and financial markets expectations have come to frustrate attempts to beat the cycle [3]. Provided monetary policy seeks to achieve medium-term expectation of price stability, it is by the same token deemed to maximise the chances of sustainable growth.

Yet, the notion of a policy mix for EMU cannot be so easily dismissed. The concept of a policy mix goes beyond the outdated idea that monetary and fiscal authorities should permanently coordinate their action with a

[3] See "Rethinking Stabilization Policy – A Symposium sponsored by the Federal Reserve Bank of Kansas City", Jackson Hole, Wyoming, 2002.

view to fine-tune the economy along the path of a predetermined growth-inflation trade off. The policy mix, indeed, is not only an ex ante planning issue, but it is also an ex post reality. At any moment, EMU will be under the dual influence of the ECB's monetary policy stance and of the combined fiscal stance of its Member States, to say nothing of the combined development of wages which also respond, to some extent, to policies carried out in the Member States.

There should be a way, lacking at present, to check that the policy mix, so interpreted, is not at odds with the common interest of the euro area. This is important in two aspects.

One is internal to EMU. There is no reason to believe that only one type of policy mix will be appropriate at any time. But there are circumstances, well documented in economic history, in which the policy mix becomes clearly inappropriate and requires correction, especially for domestic purposes.

The other reason is that the international adjustment process is continuously under discussion. If the policy mix in EMU is felt appropriate, EMU must be able to argue so. EMU representation in international fora will be discussed later, but it is pointless if there is no substance for discussion. It is inconceivable that the second world currency, by order of importance, be left to operate in an alleged economic policy vacuum for much longer.

Part of the strengthening of the economic governance of EMU thus depends on new efforts to identify the policy stance of the group of euro area members, and to give it proper recognition both inside and outside Europe. The information is available. The combined fiscal stance of the euro area can easily be found or computed from the existing documentation: it should not remain buried there. The fear that some might come to look at the monetary-fiscal mix as a genuine policy variable may explain why Member States seem keen to downplay its importance and visibility. Yet, this is where the common interest begins to take significance. The monitoring and defence of the ex post policy mix of EMU should become a regular feature of the economic debate, both inside and outside EMU.

2.3. The single and independent monetary policy

All monetary decisions are taken by the Governing Council of the ECB which enjoys full independence both at a national and at a European level. This rule means that the ECB cannot commit itself in advance to stick to a strategy agreed with governments of the euro area whatever may occur. In pursuing its prime objective of price stability, the ECB has to permanently take into account any change in economic and monetary conditions, including changes of the fiscal stance in participating countries, the endogenous evolution of economic variables and external shocks. It is thus characterised by a reaction function. However, the ECB is guided by a strategy and a target which have to be clearly explained to ensure its public accountability and its support by the economic agents.

Independence, however, does not exclude dialogue, the exchange of opinions and information. This is why many possibilities of contact have been provided for by the Treaty. So far it proved helpful that, from time to time, the representatives of monetary and fiscal policies discuss the reasons for their moves [4]. Practice may strengthen these exchanges, in particular in the light of enhanced fiscal policy coordination between Member States.

After five years, it seems clear that monetary union has worked properly from a technical standpoint. It has been successful in bringing monetary stability; inflation is no longer seen as a significant threat in Europe. However, some progress remains to be made in the communication on the appropriateness of interest rates changes. For example, it would be very helpful for market participants and ECB watchers to learn more about the pros and cons of interest rate decisions. But the ECB should, for the time being, continue to resist demands to publish the minutes of Governing Council sessions and the voting pattern soon after the meetings, as this could easily provoke political pressure on Council members and endanger the independence of the ECB.

The ECB's policy concept has been criticised because it was difficult to understand and to communicate. Thus, the ECB clarified its strategy in

[4] The president of the European Council may attend the meetings of the ECB Governing Council. Similarly, the ECB president is invited to attend sessions of the ECOFIN Council and the Eurogroup.

spring 2003, by reordering the presentation of its two pillars[5] (respectively the economic and monetary analyses) and by redefining price stability (inflation rate below but close to 2% instead of a corridor of 0 to 2**%**). The ECB aims to maintain price stability over the medium term. This allows greater flexibility in steering monetary policy, taking account among others the economic and fiscal policies in EMU.

The provisions for monetary governance have proved generally adequate for the conduct of monetary policy. However, it may not be wise that these provisions remain permanently enshrined in Treaty or Treaty-like instruments, subjecting any change to the veto of any EU member country. Except for the priority attached to price stability, it is desirable that the procedure for amending the Treaty provisions for monetary governance be exempted from the requirement of unanimity in the Council.

Relations between the ECB and governments or members of political circles have not always been smooth. The absence of a unified and responsible political counterpart to the monetary authority has sometimes led national authorities to issue statements conflicting with the responsibility and independence of the ECB. Progress towards a clearer and more consistent set of non-monetary policies should help alleviate the drawbacks of the current asymmetry between the economic and the monetary governance.

2.4. Fiscal policies

2.4.1. The challenges of fiscal discipline

There is general agreement that the working of EMU implies a certain degree of fiscal discipline, as does, indeed, the management of the economy of any particular country. Many economic tragedies and turbulence find their origin in the ignorance of that simple truth. A good historical example is provided by the collapse of the Nordic monetary union in the early 20^{th} century.

[5] The first pillar now consists of a broad set of economic and financial indicators while the second comprises the analysis of a wide range of monetary indicators including M3 and credit.

In the case of EMU, fiscal discipline is imposed on Member States through explicit rules, which are to be found partly in the EC Treaty itself (the excessive deficit procedure) and partly in Community legislation known as the Stability and Growth Pact (see Annex I - 2). The distinction is legally important, though it is not always clearly spelled out when these rules are being discussed.

Binding fiscal rules were preferred to fiscal discipline as a result of market pressure. This choice had been thoroughly reviewed when building the foundations of EMU: by way of preparatory work for the Delors' Report, the blueprint for the subsequent drafting of the Maastricht Treaty, Alexandre Lamfalussy [6] wrote a well-considered and convincing paper showing that market pressure does sanction fiscal profligacy, but only with long delays and then, often, with excessively brutal strength. Well understood fiscal rules can therefore help protect the authorities from unpleasant surprises.

Fiscal policy has a long history of disappointing effectiveness in stimulating growth and employment in Europe: more often than not, its main consequence is to increase the stock of national debt. Several countries entered the process for joining EMU with severely deteriorated public finances and, therefore, had to face a daunting challenge to meet the fiscal convergence criterion. Fiscal consolidation had to be achieved, at times, despite its pro-cyclical impact; admittedly, there was a cyclical counterweight in the associated downward path of interest rates and in the expectation of reaping the economic benefits of joining EMU.

The fiscal rules were drafted under the assumption that, irrespective of the economic cycle, the process of consolidation would be carried to the point at which a budget balance or one in slight surplus would be reached. From then on, the automatic stabilisers would be allowed to provide the needed counter-cyclical impulse, without infringing the Treaty ceiling of 3% of GDP, a ceiling that could be waived only under very exceptional circumstances. This process was in fact not carried out completely, with several countries feeling that, once the deficit was brought down within the 3% ceiling, they could no longer politically impose further sacrifices to their public opinion. As a result, a sufficient cushion was not reached to

[6] Alexandre Lamfalussy, Macro-coordination of fiscal policies in an economic and monetary union in Europe, January 1989, in: Committee for the study of economic and monetary union, Report on economic and monetary union in the European Community ("Delors' Report"), 1989.

protect against breaching the Treaty ceiling when the economic slowdown occurred.

These circumstances notwithstanding, this pillar of EMU is now being challenged both by an intellectual and policy-oriented debate over the wisdom of the rules, and by the decision of the ECOFIN Council in November 2003 to suspend the excessive deficit procedure against France and Germany. One can hardly think of worse conditions for conducting a reasoned and disinterested review of the rules. Indeed France and Germany have kept their annual budget deficit in excess of 3% of GDP for the second year running in 2003 and will again do so in 2004. Fiscal laxity raises the borrowing requirements and increases the pressure for higher interest rates once private sector demand for funds increases in the emerging economic recovery.

As for the general government debt ratio (debt as a % of GDP), progress towards the 60% level is uneven and is pursued, on average, with less determination than in the period leading up to monetary union. Belgium, Greece and Italy still post debt ratios over 100% although the decline in Belgium's debt ratio is a notable achievement. Nevertheless, the debt ratio in the euro area fell to 69% of GDP by the end of 2002, after having risen steadily for decades to peak at 75.3% in 1996. However, it was again over 70% at the end of 2003, as a result of the budgetary offenders, France's and Germany's debt rising above 60%.

These events show how arduous it is to impose discipline for the implementation of policies which are solely the responsibility of Member States. In the case of the SGP, there are specific reasons for making it particularly difficult.

First, there is a practical difficulty for governments to abide by a limit applying to a statistical result known only ex post and depending on financial flows resulting in part from existing binding legislation in areas such as health care and pension schemes. The solution lies partly in structural reforms which take time to implement. In our democracies, such basic reforms are left to the initiative of governments and parliaments and call for support from public opinion. This is precisely a field in which clear principles of coordination at European level are lacking and where there is a case for finding better rules of governance, even if based on dialogue rather than on Treaty provisions.

Second, the limits set up by the SGP have not had to be translated into national legal binding provisions, in contrast to Directives, for instance. It does not entail any change in the functioning of national institutions. It is not a directly applicable rule. Its implementation requires the voluntary cooperation of decision making bodies in participating countries and the voluntary abandonment of their power to adopt discretionary measures. This goes against the trend by which existing institutions tend to protect their competencies, all the more as they enjoy political legitimacy.

Thirdly, as drafted in the SGP, the point in time which calls for intervention as a result of breaching the deficit limit of the pact is far too late to allow for proper remedial action. It is when growth is high that participating countries should build up a surplus to act as a buffer when the cyclical downturn leads to a significant deterioration of public finance. The latter is supposed to play the role of an automatic fiscal stabiliser. There is therefore a need for agreeing on a permanent strategy.

The issue of sanctions is a sensitive one, as was apparent at the time of drafting the Treaty provisions and again in their implementation in November 2003 regarding France and Germany. It was the hope, at least of some, that the mere threat of sanctions would keep fiscal behaviour well within the permitted limits. That assumption no longer holds. After the decision of the ECOFIN Council in November 2003, it is far from certain that sanctions will be imposed at all. The de facto dilution of the pact has triggered a heated political debate. Ideally, an automatic and progressive penalty should act smoothly. It should be an incentive to comply with the rules of the SGP. The political problem is, however, that countries must be ready to sacrifice more sovereignty in fiscal policy. The view is sometimes expressed that, if sanctions are waived when they ought to apply, the fiscal rules of the SGP are dead. This may be exaggerated. If sufficient noise is made at Union level in support of fiscal rectitude, and about the dangers of a relapse into profligacy, political embarrassment may arise to the point at which it becomes in itself an implicit sanction. It might be advisable, however, to review the nature of sanctions.

2.4.2. Options for change in fiscal coordination

It has rightly been pointed out that the SGP does allow for a degree of flexibility. Indeed, a set of proposals for change, involving among others a degree of differentiation between countries, were put forward by the

Commission in November 2002 and endorsed by a resolution of the European Council in March 2003 (see Annex I - 3). In this context a useful direction for change points to the desirable differentiation of the medium-term constraints on fiscal policy according to the degree of public indebtedness of the various countries [7]. It is not unreasonable to grant more flexibility to countries with a rather low public debt ratio in comparison to countries where the debt ratio is still much above the threshold of 60% of GDP.

Many other suggestions have been made, which would carry the reform of fiscal discipline much further and would imply, in most cases, an amendment of the Treaty. Each ought to be assessed on the basis of its merits and its potential contribution to a strengthening of the common interest in the management of the economic union.

One proposal for improving coordination consists in excluding some categories of public expenditure from the computation of the budget balance. For instance, the suggestion has been made to exclude the share of public expenditure devoted to investment and research from the calculation in order to shield these priority expenditures from undergoing cuts induced by the required fiscal discipline. While such selectivity deserves careful attention when looking at the package of public expenditure in the framework of structural policies, or when exercising judgement within the leeway provided by the terms of the SGP, its consistency with the purpose of designing the perimeter of fiscal discipline, in the context of monetary union, is less convincing. Indeed, the rationale for fiscal discipline lies in control of debt creation associated to any budget deficit. Once markets start focusing on the excessive size of the debt and the borrowing requirements, the composition of the underlying public expenditure becomes secondary. Moreover, classifying expenditures according to their growth enhancing virtue is a hazardous exercise. It would open a Pandora's box of requests to change the method of calculation.

Another proposal is to take into account the underlying structural balance rather than the reported nominal balance. It differentiates between a cyclical component and a structural component. Under such an amended SGP, the structural balance should be close to zero, while the cyclical

[7] This proposal is also made by Marco Buti, Sylvester Eijffinger and Daniele Franco, Revisiting the Stability and Growth Pact: grand design or internal adjustment? European Economy, N° 180, January 2003.

pluses and minuses should offset each other over the full life of the cycle. It is gratifying to note that the ECOFIN Council endorsed the IMF/OECD method in 2001 for determining the cyclically-adjusted budget deficit. Accordingly, the Commission itself refers to the notion of a structural deficit. Had this proposal been in force, the German fiscal dilemma in 2003 would have become less dramatic and would have encouraged the German government to take measures in time to correct the structural deficit which had been rising since 2000.

As a major step towards a genuine European economic governance, one could also consider substituting a permanent institutional surveillance for binding fiscal rules. This would imply a much tighter collective steering of the policy intentions of Member States than currently achieved, structured as follows:

- reach a consensus on the most appropriate fiscal stance for the euro area as a whole, based on statistics, forecasts and analysis provided by the Commission;
- draw a profile for the future, as a strategy develops over time;
- decide on the burden sharing among participating countries, based on the understanding that national administrations, governments and parliaments will cooperate in a spirit of fairness;
- decide which country should adjust in case of a deviation from the path previously agreed. Such cases should remain exceptional. Budget offenders, if any, should bear the brunt of the adjustment, to avoid penalising the best performers or condoning a bail out.

Admittedly, such a scheme lies at the borderline of a transfer of fiscal sovereignty and may not be realistic in the present circumstances. However, it points to the direction of a differentiated but collectively managed fiscal discipline, one important component of a strong economic governance.

None of the proposals described above tackles the issue of the appropriate sanction for breaching the commitments which Member States enter into by virtue of the SGP. Yet, as financial sanctions have proved to be essentially unworkable, the search for alternatives should be undertaken. The next section suggests a reform of the SGP which would combine elements of the previously described proposals and an alternative regime for sanctions.

2.4.3. Towards a two-layer SGP

The new system of fiscal discipline suggested hereafter would involve two layers of provisions.

The first layer would consist of a new uniform binding rule, whereby the budgetary commitments by participating Member States would no longer focus on nominal deficits, but rather on structural or cyclically-adjusted balances, as discussed above. The target for such balances would be zero, implying a symmetrical obligation to generate a nominal surplus or a nominal deficit, depending on the point reached in the economic cycle. Since over time, such a target would engineer a trend decline in the debt to GDP ratio, the target could be moved at some point to allow a modest structural deficit. The breach of such commitments, if any, would no longer be subject to financial sanctions, but would activate a special multilateral surveillance under the second layer of provisions.

The second layer of provisions would consist of a much tighter multilateral surveillance process than hitherto, under the control of the Commission. Firstly, quarterly or, if needed, ad hoc assessments should be carried out, focusing on both the aggregate and the individual stances of fiscal policy, and taking into account a set of economic factors such as debt ratios (both actual and prospective, taking account of contingent liabilities such as pensions, and the consequences of ageing), current balances, the composition of expenditures, etc... Secondly, if deemed appropriate, the Commission should trigger special consultations with national authorities, at a very early stage, and, as the case may be, issue recommendations to one, several or all countries, which the Council, in its euro area restricted format, would adopt by qualified majority. In formulating such recommendations, the Commission should be entitled to suggest that the commitments of Member States under the first layer of provisions be overruled, either to soften or to strengthen them, the guiding principle being the common interest of the euro area. Thirdly, a breach of such recommendations, by a Member State, should, after a statutory period, entail the temporary but renewable suspension of the voting rights of the infringing Member under all provisions relating to fiscal policy.

Admittedly, extensive amendments would need to be brought to the Treaty provisions to implement such a scheme. Its implications for non-EMU Member States and for the fiscal convergence criterion would need to be thoroughly examined.

CHAPTER 3
THE COORDINATION OF STRUCTURAL POLICIES

3.1. Common features of structural policies

The dividing line between macro-economic and structural policies is not watertight. Growth and employment are objectives common to both. Price stability is usually seen as belonging by essence to macro-economics, being a precondition for sustainable growth. In macro-economics, there has also been a fierce debate about the trade off between price stability and the level of unemployment. In this context the "Nairu" [8], which measures the risks that a tight labour market may fuel inflationary trends, can only be influenced by structural policies.

Structural policies and reforms encompass many policy areas falling under different degrees of EU involvement and competence. It is important, for the purpose of governance, to underline a number of features both common and specific to structural policies.

Firstly, these policies encompass a wide range of domains, such as single market issues, employment and social policies, the level and the structure of taxation and public expenditure, research and development, education, environmental priorities, etc... In some areas, closely related to single market issues, EU legislation is the driving force behind convergence or harmonisation, usually at EU level rather than for the euro area alone. In other fields, where the principle of subsidiarity leans towards decentralisation, the common interest is nevertheless captured, either under the Broad Economic Policy Guidelines, or under the open method of coordination, or both.

Secondly, their linkage to the credibility of the single currency is less obvious than in the case of macro-economic policies, though by no

[8] Nairu is the non-accelerating inflation rate of unemployment. A number of mainstream economists argue that the long-run potential US growth rate is about 2.5% per year and that the natural rate of unemployment is in the 5.5-6.0% range. If unemployment would fall below its natural rate and output grow above its long-term potential rate, inflation would start to increase because of bottlenecks in production and the labour market.

means absent, as the contribution of structural policies to long-term growth is an indispensable complement to the concerns about stability. However, given their longer-term horizon, there is no compelling reason for seeking specific EMU provisions when discussing the need to strengthen governance.

Thirdly, to the extent that they contribute to growth and employment, they do so by influencing the growth potential of the economy rather than the balance between supply and demand. Their importance flows from the widespread recognition that, since the late eighties of the last century, the growth potential of the European economy has been lagging.

Fourthly, they respond to a variety of specific objectives, not only the macro-economic dimension of growth and employment. As such, they are highly sensitive in public opinion and need to be addressed with great care to elicit support from a wide base. In many cases, these policy areas are covered by special chapters of the Treaty on the European Union, not just by the provisions relating to the coordination of economic policies.

Fifthly, the involvement of the European Union in shaping structural policies has considerably intensified over time, across the distribution of competencies between the Union and Member States. Community legislation is scarce, admittedly, as the influence of the Union is channelled through orientations, guidelines, strategies and agendas, usually adopted at the highest policy level, namely by the European Council. A recently published compendium of extracts from the Presidency Conclusions of the European Council concerning the "Lisbon strategy", over the years 2000-2003, takes 140 pages, only four of which deal with the coordination of macro-economic policies [9].
However, the whole field resembles an inverted cone, the upper surface of which is abundantly filled with Community or Community-related meetings, literature and decisions while, on the ground, the impact of such activity remains conspicuously thin. Moreover, where such impact can be detected, the public awareness of its European dimension is abysmally low. While the second section of this chapter identifies the key areas calling for consideration, the third section seeks possible avenues to improve governance.

3.2. The scope for structural policies

[9] See http://www.europa.eu.int/comm/lisbon_strategy/index_en.html

In modern societies, all governments run policies with respect to the structural or micro-economic features of the economy, such as enumerated above. The process of globalisation creates incentives for emulation between countries, or entails spill-over effects, so that international coordination seems logical and desirable. Much of the OECD's activity is carried out along this line.

In Europe, a higher level of ambition adds an element of intensity and urgency to this process, and leads to the identification of key areas where structural policies should be upgraded to the status of structural reforms. The EU reform agenda by 2010 was formulated by the Lisbon Summit in March 2000.

Main messages of the Lisbon Summit

"These changes - note: globalisation and the challenges of a new technology-driven economy - require a radical transformation of the economy." (§ 1)

"The Union has today set itself a new strategic goal for the next decade: to become the most competitive and dynamic knowledge-based economy in the world,

- capable of sustainable growth
- with more and better jobs
- and greater social cohesion" (§ 5)

"Achieving this goal requires an overall strategy aimed at:

- preparing the transition to a knowledge-based economy and society by better policies for the information society and R&D;
- as well as by stepping up the process of structural reform for competitiveness and innovation and
- by completing the internal market;
- modernising the European social model, investing in people and combating social exclusion;" (§ 5)

"This strategy is designed to enable the Union to regain the conditions for full employment and to strengthen regional cohesion in the European Union" (§ 6)

There is considerable variance in the extent to which the Union is entitled to act in these fields, relative to Member States. Taking, for instance, the completion of the internal market, the European Commission has a strong say in ensuring that the rules for fair competition are observed. In many areas regarding the market for goods, services and capital, the standard Community legislative process applies. The Lamfalussy process has inaugurated a new style of decision-making applicable to the regulation of the capital market and likely to extend to other financial areas. Member States, however, keep the last word when issues of taxation are concerned, as the rule of unanimity applies in the Council in this field.

One also observes shifts in emphasis as the Presidency of the European Union moves from one country to the other and the European Council from one city to another. Luxemburg is remembered for stressing employment, Cardiff for pushing the implementation of the single market for goods and services, Lisbon for highlighting the need to develop the information society, Gothenburg for insisting on the environmentally sustainable growth. Lately, the "Growth initiative" has endeavoured to bring to the fore a renewed drive for investment in infrastructure, more particularly in trans-European networks.

The European Central Bank and other observers insist repeatedly on the urgency of completing the integration of the European financial market, of enhancing the flexibility of the labour market and adjusting the social protection systems to the problem of ageing populations, three areas each of which can decisively influence the prospects for higher growth and sustainable public finances and therefore carry important implications for alleviating the strains on the SGP and on inflationary expectations.

3.3. How to improve governance

In the case of structural policies, improving the economic governance of the Union cannot possibly mean the handing over of all the keys to the European institutions. Not only would the principle of subsidiarity stand in the way of such centralisation but the instruments which are used for implementation, namely regulations, taxation policy, public spending, etc... are overwhelmingly handled by Member States. This is as it should be, to the extent that few domains call for outright harmonisation.

However, the cone must be put back on its upright position. Ways should be found to make sure that the impulse coming top down from the Union becomes pointed, coherent, consistent and readily understandable, while ways are found to irrigate in depth the very foundations of the European economies with commensurate and consciously coordinated actions. In other words, the desirable strengthening of governance should involve streamlining the basic European-wide message, restoring appropriate linkages between the well established rhetoric, at European level, and the implementation of national policies on the ground, and making sure that this process permeates public opinion.

3.3.1. Streamlining the European-wide message

Much has been accomplished already to rationalise and synchronise the annual economic and employment policy coordination cycles. The impression remains that the aggregation of different processes (Luxembourg, Cardiff, Cologne ...) amounts to a tiresome bureaucratic process, periodically subjected to new attempts at rejuvenation as the Presidency of the Union moves from one country to another. Perhaps a lengthening of the mandate for the Presidency, as proposed in the Draft Constitutional Treaty, could help tilt the balance in favour of greater interest in the implementation of existing policy intentions, relative to the search for new initiatives. The European Commission should be encouraged to suggest ways of further prioritising between the goals pursued and to incorporate the diversity of the European messages in a coherent and condensed set of measurable standards the progress of which could be monitored. The Broad Economic Policy Guidelines form the backbone of the coordination of structural policies.

3.3.2. Restoring appropriate linkages from top to bottom

There is a need to bridge the hiatus between the discussion of structural policies at European level and the relevant debates and actions at national level. While the information circuits do not seem to be lacking, the political processes are not designed in a way which allows dynamic interaction. One promising development, however, is the emergence of the open method of coordination (OMC), which the Lisbon agenda has upgraded to the status of an important new Community instrument. The following quotation illustrates this point: "…the OMC has so rapidly become a virtual template for Community policy-making in complex, domestically sensitive areas where diversity among Member States precludes harmonisation but inaction is politically unacceptable, and where widespread strategic uncertainty recommends mutual learning at the national as well as the European level." [10]

Since Union-wide legislative process is not available in many of these structural policy areas, the open method of coordination is a useful way to bring the common interest to bear with some weight on matters which lie under the undisputed competence of Member States. Among the most important features of this instrument are the development of structural indicators, the practice of benchmarking, the surveillance and evaluation exercises, widespread consultations and the catalytic role of the European Commission. Surely, care must be taken that this method does not substitute for stronger Community prescriptions when the Treaty provides for them. On the contrary, the method should help identify cases where such stronger involvement should be contemplated. In any case, the role of the European Commission in this process should be strengthened. The case for making use of the Treaty provisions on enhanced cooperation between willing Member States, in some of these areas, might also be carefully explored.

3.3.3. Involving public opinion

Enlisting public opinion for stronger economic governance at European level is a major challenge. It cannot be solved by intensifying the top down information flows alone, nor can it be seen only as a public sector responsibility. A better interaction between the political processes at European and at national level should be promoted by business federations, trade unions, NGO's, etc... Many NGO's seeking to foster the process of European integration focus their efforts on the discussions and procedures operating at the European level, but fail to show much interest in bringing the European dimension to bear on local discussions and procedures.

To sum up, improving governance for a more efficient implementation of structural policies in the European Union could be a decisive contribution to stronger growth and employment. The enlargement of the Union brings in countries which have undergone a dramatic degree of structural

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[10] Grainne de Burca and Jonathan Zeitlin, Constitutionalising the Open Method of Coordination, What should the Convention propose? CEPS Policy Brief, No.31 March 2003, page 2.

adjustment to qualify for accession, with severe implications for the individual standing and behaviour of enterprises and households, but also with clear dividends for both actual and potential growth in these countries. In the catching-up process, these countries could serve as an example for the other Member States where entrenched traditions stand in the way of adjusting to the new environment.

CHAPTER 4
INSTITUTIONAL ASPECTS

4.1. European Convention: little transfer of policy competence

The European Convention was charged with drafting a Treaty revision and a European Constitution in order to make the Union fit to face the future after the enlargement in May 2004. In this context, definite progress in terms of economic governance was expected by several observers. It was hoped that the Convention would seek to eliminate the administrative hurdles to economic integration and propose a clear set of procedures to reinforce economic governance in the EU as a whole and EMU in particular.

The Draft Treaty presented by the European Convention in July 2003 contains encouraging as well as disappointing elements. It is disappointing insofar as the working group on Economic Governance chaired by MEP Klaus Hänsch, was unable to agree on the desirable level of European involvement in economic policy issues. There is little or no transfer of authority from the national to the European level. The Constitution makes no real progress in bridging the gap between economic and monetary governance in EMU.

One bone of contention is the wording of the general economic objectives. The Draft Constitution proposes in Title I, Art. 3.3. to create "sustainable development" with a "balanced economic growth", a "highly competitive social market economy that tends toward full employment, social progress and a high level of protection and improved environmental conditions" [11]. Unfortunately, non-inflationary growth is not mentioned explicitly. However, price stability should also be inserted as a main objective of the Union in order to underline that price stability is a key pre-requisite for sustainable growth and that it has to be taken seriously.

But there are also some additional topics which deserve to be taken into account when the negotiations on the Draft Treaty resume after the failure

[11] Strangely, the former objectives of "harmonious development" of the Treaty of Rome and the "market economy where competition is free" of the Maastricht Treaty have been retained in Articles III – 69 and 116.

of the IGC to wind up its work in Brussels in December 2003. In the field of taxation, the Working Group on economic Governance pleaded in favour of switching to qualified majority voting in those instances where a clear link could be established to the proper functioning of the internal market. A merit of the Group was to resist the call from Civil Society to broaden the objectives of the ECB to include economic and social goals. On the positive side there are also proposals to improve the decision making process.

4.2. …but new dispositions regarding economic governance

Economic governance could be improved to some extent by a series of overall new dispositions proposed in the Draft Constitution. The present system of rotating Presidencies of various Councils, including the ECOFIN, would be abandoned and the different formations would be chaired by ministers from different countries for a period of at least one year under practical arrangements to be worked out. Councils would exercise legislative as well as executive functions in what could turn out to be the most important progressive move toward the future establishment of a genuine European Federal State by the development of a second legislative chamber besides the European Parliament. Qualified majority voting would gain significant ground: unanimity voting would be reduced from 81 instances in the present Treaties to 54 cases. As from November 2009, qualified majority would be defined as a simple majority of Member States in the Council representing at least 60% of the Union's population. The European Parliament also gains in importance: co-decision procedure together with the Council would become the rule by default. The Parliament would also elect the President of the Commission among candidates proposed by the European Council.

The Convention also proposes to develop enhanced cooperation among those Member States that want to integrate faster than the EU as a whole. This may prove useful considering the weak constitutional proposals in the field of economic governance, but it entails the danger of a multi-speed Europe or even a Europe "*à la carte*" which would prove even more difficult to govern than heretofore. Generalising this principle could lead to a dilution of the "*acquis communautaire*" rather than a more politically united Europe.

The European League for Economic Cooperation has strongly recommended that, as a minimum, the IGC adopt the provisions of the Draft Constitution. Beyond that, however, the Convention heard various suggestions to reinforce the EU economic governance that did not obtain adequate support but should deserve more attention:

- the adoption of Broad Economic Policy Guidelines (BEPG) on the basis of proposals rather than recommendations of the Commission;
- replacing of unanimity voting by extended qualified majority in matters of taxation and relevant policies connected with the operation of the single market;
- creation of a post of “European Minister of Finance and Economic Affairs” who would represent the euro area in international fora and who could chair the Eurogroup.

4.3. ELEC proposals for changes in economic governance

4.3.1. Reinforcing the Eurogroup

There are good reasons to downplay the political distinction between the euro area and the European Union. Although not all EU members share the single currency, many of the policies deemed desirable for the working of EMU are also desirable for the working of the single market. And there are drawbacks associated to the emergence of an institutional duplication within the Union. While the finance ministers of all EU members meet in the composition of the ECOFIN Council, the same ministers representing EMU members also meet as the Eurogroup. The informality of the Eurogroup is seen, at least by the ministers who sit there, as a comfortable compromise between the singularity of EMU issues and the unambiguous decision making forum of the ECOFIN Council.

The cost of this compromise is that the collective consideration of matters of common interest to EMU is buried in confidential caucuses, or identified with the common interest of the Union, irrespective of the currency arrangements. This cost is bound to increase over the next years as the number of non-EMU EU members rises. After EU enlargement in May 2004, the euro area countries will even be in the minority in the ECOFIN Council (the ratio being 12:13 countries).

It is understandable that Ministers of Finance should appreciate the club atmosphere of the Eurogroup, maintaining some distance from their other colleagues. There is a point, however, when the input of the full weight of governments is needed to formulate and implement a coordinated fiscal policy. The same holds true for formulating exchange rate policy, as the emergence of the strong euro vis-à-vis the dollar has shown in 2003/2004. For example, if the monitoring of the fiscal discipline is to be tightened along the lines suggested above, ministers will have to be entitled to take decisions for the sake of – and limited to – EMU. Thus, the Eurogroup needs to be given a greater role in policy coordination in order to improve economic governance. Therefore, ELEC proposes to raise the status of the Eurogroup from an informal gathering within ECOFIN to a formal separate body [12].

4.3.2. Enhanced role for the Commission

The European Commission's role in its surveillance function should be reinforced. It would be entitled to issue a "direct" warning to a Member State, not only in case of a lax fiscal policy within the framework of the SGP. The Broad Economic Policy Guidelines (BEPGs) are an important field which includes elements of economic and fiscal policies as well as structural policies; so far, they have the character of recommendations which have only a soft influence on the conduct of national economic policies. The Commission should receive a mandate of enhanced surveillance in the event that economic policies are not consistent with the BEPGs. Moreover, they should be communicated more strongly to the media in order to strengthen the perception that their implementation is policy-relevant in the public opinion. In this context, ELEC argues that ECOFIN decisions should be taken on the basis of Commission proposals instead of weaker recommendations without the Member State concerned being able to participate in the voting [13]. This is expected to put more peer pressure to stick to the agreements made within the framework of BEPG. They should cover all economic aspects of

[12] So far, the Eurogroup had only been mentioned in the European Council conclusions of December 1997. The Draft Constitution (Part III, section 3b) describes the composition and the tasks of this body. It lists the issues for which the voting rights within the ECOFIN Council are restricted to Members of EMU. A President of the Eurogroup would be elected for two years at a time.

[13] This exclusion should be generalised in all European Institutions and areas. It is now only a formal and well accepted procedure in the European Court of Justice.

competencies of the EU specified in Title III of Part I of the Constitution, including shared competencies and areas of supporting, coordinating or complementary action.

4.3.3. Switch to more majority voting

Modifying the future Constitution will require unanimous agreement from all national governments, and ratification by all EU Member States. The Nice Treaty was not only unsatisfactory in terms of its content, but it also demonstrated that the EU institutional framework could be prevented from evolving in areas where Member States retained veto right. Nice was the last in a series of Inter-Governmental Conference (IGC) that failed to meet the expectations of the Maastricht Treaty. The Laeken Declaration originated in the recognition that modifying the institutional arrangements among 25 Member States would certainly be no easier than among the existing 15. Hence, the need to change the Draft Constitution, so that, as a minimum, amendments to its provisions relating to policies are taken by a special majority voting procedure rather than by unanimity.

4.3.4. New institutional framework for an economic governance of EMU

Today, a decision to equip EMU with an economic government is unlikely as the institutional structures and the political will are missing. However, intergovernmental cooperation – enhanced or not – among 25 autonomous economic entities cannot provide a sustainable institutional framework to handle issues of common interest in the single market and/or EMU.

A centralised economic decision making process is required to handle these issues in the EU – and in EMU in particular – in a credible way as an interface with major competitors in the world market. Ideally, that structure should parallel that put in place for the monetary side of EMU. The Eurosystem – the ECB and the national central banks – has proved its efficiency in monetary affairs. The Ministries of Finance and Economy of Member States should operate together with the General Directorate for Economic and Financial Affairs of the European Commission under networking procedures similar to those adopted by the national central banks with the ECB. The President of the Eurogroup, chosen among its members, should also become the Minister of Economy and Finance of the Union as well as, possibly, the Commissioner of the above-mentioned General Directorate. He would become the economic counterpart of the President of the ECB in European and international fora.

CHAPTER 5
EXTERNAL REPRESENTATION OF EMU

5.1. A mixed bag of responsibilities

The implementation of monetary union among twelve states involved the substitution of an equal number of currencies by a single currency, the euro. Two important currencies of the world, the DM and the French franc disappeared and the euro substituted for them in the SDR basket. Monetary union introduced an important novelty in the institutional structure of the European Union. EMU Member States transferred their competence in monetary policy and – as far as day-to-day operations are concerned – in exchange rate policy to the ECB as a supranational authority. This qualitative change in the powers of the States has, of course, repercussions on the international monetary system and its institutional set up.

Now that the monetary union has successfully been completed within the participating Member States, it is time to turn outward and ensure that new monetary realities within the EU are better reflected internationally. In principle, EMU should give Europe greater clout in international monetary affairs. However, this has not materialised because the external representation of EMU is still based on the spreading of responsibilities between the ECB, the European Council, the European Commission, and – e.g. regarding international fora such as the G7 – also some individual Member States, diluting the power of the Union accordingly.

5.2. The case of EMU and IMF

As far as the IMF is concerned, only marginal changes have taken place. As from 1 January 2001, the weight of the euro in the SDR basket has been redefined to take into account indicators common to the whole euro area. The ECB was granted observer status [14] at the IMF since the start

[14] The ECB observer participates in all meetings of the IMF Executive Board regarding the surveillance (under Art IV) of the euro area and individual EMU Member States, the role of

of EMU on January 1, 1999 in order to enable the ECB to express its views in the IMF Executive Board.

The Community's position may be presented to the Executive Board of the IMF by the Executive Director – or by a member of his office – whose Member State exercises the Presidency of the Council of Ministers, assisted by a representative of the Commission. Some coordination has been provided, within the EU Economic and Financial Committee and the Eurogroup, in order to arrive at common positions between EMU Member States in the organs of the Fund. Consultations under Article IV take into account the fundamental change occurring in the economic and legal contexts. But, as a rule, pragmatism is the leitmotif and this situation is far from being satisfactory because the members of the IMF that have become involved in the monetary union have lost most of their influence within the Fund, and a structured European representation has not been organised to replace it.

The participation in the IMF and the representation in its bodies are still organised as if EU Member States, participating to the monetary union would have preserved their former competence. The economically most important states have a seat in the IMF Executive Board. Others are part of constituencies that include third countries. Under such arrangements, it is very difficult for the euro area to speak with one voice as do the US for the dollar and Japan for the yen. The unity, even if achieved internally, is not sent as a clear message to the outside world. The quotas are still calculated as if trade within the economic union were external trade, which leads to what some consider as an over-representation of Europe.

The solution to the problem of an adequate representation of the euro area is not easy. The Articles of Agreement of the IMF provide for the participation of countries and not of "international organisations". It is a "country-based" not a "currency-based" organisation. A second handicap is the non-coincidence between EU and euro area membership. But taking into account that the individual EMU Member States are no more candidates for drawing on Fund facilities, should not the euro area be considered as a "country" for the purposes of the IMF Articles of Agreement? Basically, either the Articles are left unchanged but interpreted to consider EMU as a country, or they are adapted to allow for the representation of currency areas.

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the euro in international monetary system and financial markets as well as the IMF World Economic Outlook.

ELEC is calling for a political arrangement within existing Articles allowing the decision-making bodies of the IMF to interpret the euro area as a country-like entity and treat it as if it were a country. Rules should be agreed in advance to order to adapt the quotas to the entry of a new member country in the EMU without having to proceed each time to a revision of the quota. Such an arrangement would, of course, also apply to other monetary unions like the Union Economique et Monétaire de l'Afrique de l'Ouest (UEMAO) for example. Such an arrangement could smooth some problems associated with modifying the Articles in order to create a euro area constituency at the Board of the IMF. One disadvantage is that such a constituency cannot be rearranged each time a new EMU participant country would join.

Applying for a change of Articles involves the risk of opening a Pandora's box, as it would give the opportunity to put many other issues on the table. The modification of articles might, inter alia, trigger a debate about voting rights within the IMF, for instance on the part of LDC or other new players on the world scene, which will not like to have another power in addition to the US which could veto the most important decisions of IMF.

Clearly, obstacles to a better insertion of the euro area in the IMF also come from the EU itself.

First, the status of all the EU Member States vis-à-vis the monetary union is not uniform. There are States with an exemption to the third stage of EMU: the UK and Denmark, and one other country with a self-assigned derogation status, namely Sweden. With the accession of new members to the EU, the number of "States with a derogation" is expected to dramatically increase at least for some time. The first among the new acceding countries to join EMU are expected to do so in 2007. That situation represents a difficulty for the unitary affirmation of the EU in the monetary field but there are ways of solving the problem if there is a political will to do so. After all, the non-participation to the single currency is de jure or de facto a provisional situation for a Member State of the EU.
Second, there is an asymmetry between economic and monetary union under the EU Treaty. In the economic chapter of EMU, there is no transfer of competence comparable to the one realised in the monetary sector and it is undeniable that the competence of the IMF also concerns a range of macro-economic policies, notwithstanding the basic role of the Fund is monetary and financial stability. Hence, a single representation of the

euro area in the IMF would reach beyond monetary policy. For instance, exchange rate arrangements for the euro are to be adopted under Article 111 of the EC Treaty, by the EU Council, in close collaboration with the ECB. Since in several national States the central bank and the ministry of finance share the representation in the bodies of the IMF, it should not be impossible to agree on a cooperative model fitting the EU.

5.3. Other areas of external representation

The IMF is not the only body where a unitary representation of the euro area should be provided. The ECB is represented as an observer in a lot of international organisations and caucuses (OECD, G7, Basel Committee, etc…). The President of the ECB participates in the G7 meetings perhaps on a more regular basis than the Commissioner responsible for Economic and Financial Affairs. There is room for improvements in that field also.

In the long run, it will not be acceptable that euro area Member States continue to express their voice in fields where they are either incompetent or have commitments to coordinate their policy within the Union. The international scene cannot be used as a means of undoing the solidarity achieved within the Union or to escape the discipline imposed by the Union. The euro area should speak with one voice and a single representation should be organised for the whole field of EMU, the question of the allocation of competencies between the Union and Member States being an internal question for the euro area.

Obstacles are important. They are both internal and external. As a matter of fact, the insertion of the Euro area within the international monetary system does not only imply technical negotiations with the IMF and other international financial and monetary institutions and caucuses. It supposes a clear view on the future architecture of the system and of its management [15]. It puts on the agenda the delicate question of the

[15] See recent contributions to this topic, more particularly axed on the IMF: L. Bini Smaghi, "A single seat in the IMF?, January 2003; W. Kiekens, "What Kind of External Representation for the Euro", June 2003, www.oenb.co.at; G.Mathieu, Dirk Ooms, Stéphane Rottier, "The Governance of the International Monetary Fund with a Single EU Chair", *Financial Stability Review,* 2003, p. 173 et s. For a study on the governance of the Fund, see Leo Van Houtven, *Governance of the IMF. Decision Making, Institutional Oversight, Transparency, and Accountability*, Pamphlet Series, N° 53, IMF, 2002. On

respective weight of the industrialised and developing world within these organisations. The Union should take the lead in order to promote a more transparent and effective international system. It is one of the challenges evoked in the Draft Constitution in the impressive list of objectives for its external action [16]. But a solution for the representation in the IMF should not be subordinated to the resolution of the whole problem of World governance. The representation of EMU cannot remain segmented [17] because it impedes an efficient projection of the euro abroad.

5.4. Key issue: ensuring a single voice

Arguing in favour of improvement of external representation of EMU should go hand in hand with the establishment of a single voice which is a "must" if EMU and the euro are to enjoy world-wide credibility. But the single voice must be supported by a stronger background of common interest considerations. This should be reflected in the monetary and economic policy structures of EMU.

External representation by the President of the ECB is not sufficient as it is limited by the mandate of the ECB. The suggestion of the European Convention to designate a "Mr. Euro Area" by electing a Chairman for the Eurogroup with a term of 2½ years is an important step to establish more visibility and continuity in international representation of EMU (see also Annex II).

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general aspects on the participation of the EU/Euro area to international organisations and caucuses, see Jean-Victor Louis, "Les relations extérieures de l'Union économique et monétaire , in E. Cannizzaro (ed.), *The European Union as an Actor in International Relations*, Kluwer, 2002, p. 77 et s.

[16] See for example the reference in Article III-193, §2, sub h) to the promotion of an international system based on a closer multilateral cooperation and a good global governance.

[17] See in particular, Bini-Smaghi, *op. cit*., p. 17.

Annex I

1 - Survey on economic policy coordination within the EU

Annex I

2 - Basic rules of the Stability and Growth Pact (SGP)

The EC Treaty (Article 104) obliges Member States to avoid excessive budgetary deficits, defined by a reference value of 3% of GDP. Article 104 also sets out a procedure in order to identify and counter such excessive deficits, including the possibility of financial sanctions. To make this a more effective deterrent, the SGP clarified and speeded up the excessive deficit procedure (EDP). The EDP refers to the procedure as specified by Council Regulation 1467/97 included in the SGP.

Identifying an excessive deficit and requesting the Member State to correct it

The EDP sets out schedules and deadlines for the Council, following reports from and on the basis of opinions by the Commission and the Economic and Financial Committee, to reach a decision that an excessive deficit exists. Such a decision is taken within three months of the reporting deadlines for government finances of March 1 and September 1 each year established by Council. A government deficit exceeding the reference value of 3% of GDP is considered exceptional and temporary and not subject to sanctions when:

- it results from an unusual event outside the control of the Member State concerned and has a major impact on the fiscal position;
- it results from a severe economic downturn (if there is an annual fall of real GDP of at least 2%).

In case of a decline of GDP of less than 0.75%, the deficit will generally be regarded as excessive. If GDP falls by more that 0.75% but less than 2%, it is up to the ECOFIN Council to decide by qualified majority that the deficit is excessive.

In the event of an excessive deficit, the Council makes recommendations to the Member State concerned and establishes a deadline of four months for effective corrective action to be taken. In the absence of special circumstances, such action is that which ensures completion of the correction of the excessive deficit in the year following its identification. If, after a progressive notice procedure, the Member State fails to comply with the Council's decisions, the Council normally decides to impose sanctions, at the latest, ten months after reporting of the data indicating an excessive deficit exists.

Sanctions

Sanctions first take the form of a non-interest-bearing deposit with the Commission. The amount of this deposit comprises a fixed component equal to 0.2% of GDP and a variable component linked to the size of the deficit. Each following year the Council may decide to intensify the sanctions by requiring an additional deposit, though the annual amount of deposits may not exceed the upper limit of 0.5% of GDP. A deposit is as a rule converted into a fine if, in the view of the Council, the excessive deficit has not been corrected after two years.

Source: European Commission

Annex I

3 - Council resolution proposals to strengthen the SGP

In November 2002, the European Commission put forward five proposals to improve the interpretation of the SGP within the existing legal framework. They were endorsed by a resolution of the European Council in March 2003:

- A first concern is to strengthen the surveillance role of the Commission throughout the economic cycle. In boom times, the structural deficit is to serve as a yardstick to see whether the budget is close to balance or in surplus.
- Second, EMU countries with a structural deficit would be required to reduce the same by at least 0.5% of GDP each year.
- Third, the Commission proposes to regard lax fiscal policy in good years as a violation of the SGP and punish offenders with an early warning.
- Fourth, it intends to reinforce the incentives for implementing the Lisbon strategy. Countries whose budget is close to balance and whose debt is less than the reference value of 60% of GDP can introduce structural reforms with budget relevance (e.g. tax cuts), but must maintain an appropriate distance to the still valid 3% limit.
- Fifth, greater weight is to be attached to the sustainability of fiscal policy. EMU countries whose debt level far exceeds 60% of GDP shall in future have to commit in the framework of their stability programme to a long-term strategy to reduce debt. If they fail to do so, they will – as with a breach of the 3% budget ceiling – face an excessive deficit procedure and subsequent sanctions.

Annex II

1. - The Draft EU Constitution and the international relations of the euro area

Article III-90 includes an interesting provision about the external projection of the euro. Paragraph 1 provides for the adoption of common positions and Paragraph 3 concerns the unified representation within financial institutions and conferences. Paragraph 1 is a step forward to be welcomed because it will hopefully restore the competence of the institutions in a field where Finance ministers used to prefer the informal way offered by the Eurogroup in lieu of the formal procedure provided by Article 111, paragraph 4 of the present Treaty. One will regret that QMV introduced by the Nice Treaty in this Article will not be the automatic rule anymore. It will depend on the voting provision applicable in the internal sphere for the matter concerned. Furthermore, paragraph 3 does not introduce an obligation for the Council to aim at a "single chair" for the Euro area. The paragraph provides only for an enabling clause and fails to demonstrate a firm political will to succeed in this direction.

Two points are to be considered that are linked but can be distinguished: the presentation of a common position in international fora and the question summed up in proposals made during the Convention works: the "single chair". Needless to say, the second is less easy to realise than the first one, although it is only through a unified representation that the euro area will truly appear as a unified economic area. Unfortunately, very often, the request for a single chair appears almost as a slogan without a clear content.

Annex II

2. - A Federal Budget

The prerequisite for a more centralised economic policy is less a political union than a centralised management with minimum own fiscal resources. The McDougall [18] report, issued shortly after the Werner report, had explored precisely that question and had ventured to set the threshold of such fiscal significance at 5% of GDP.

Today, the EU budget represents a maximum of 1.27% of GDP, while national public spending amounts in the EU to 45% of GDP, varying between 33.7% (Ireland) to 58.2% (Sweden). These percentages compare with 33.8% in the USA and 30.6% in Japan. In the EU, they have tended to decrease, but the continuation of this trend will be difficult to achieve particularly in countries with high public debts and in general, in the absence of more radical changes in pension schemes and in a greater degree of pooling of public services. The comparison between the close to 1% of taxes devoted to common European goals and the 45% of average national taxation demonstrates how far the EU is still from its implementation of an Economic Union, especially given the fact that close to half of the EU budget is devoted to agriculture.

Economies of scale and spill-over effects should lead national authorities to nourish after-thoughts on the wisdom of some of their own public programmes. A thorough study is recommended to scrutinise the relative merits of a separate or joint funding of the various public activities. It might, for instance, lead to the conclusion that payments for education, social security, national debt service, are best handled at national level, while the pooling of subsidies to the economy, of spending on research, large infra-structural investments or international co-operation would be more efficiently carried out from the centre.

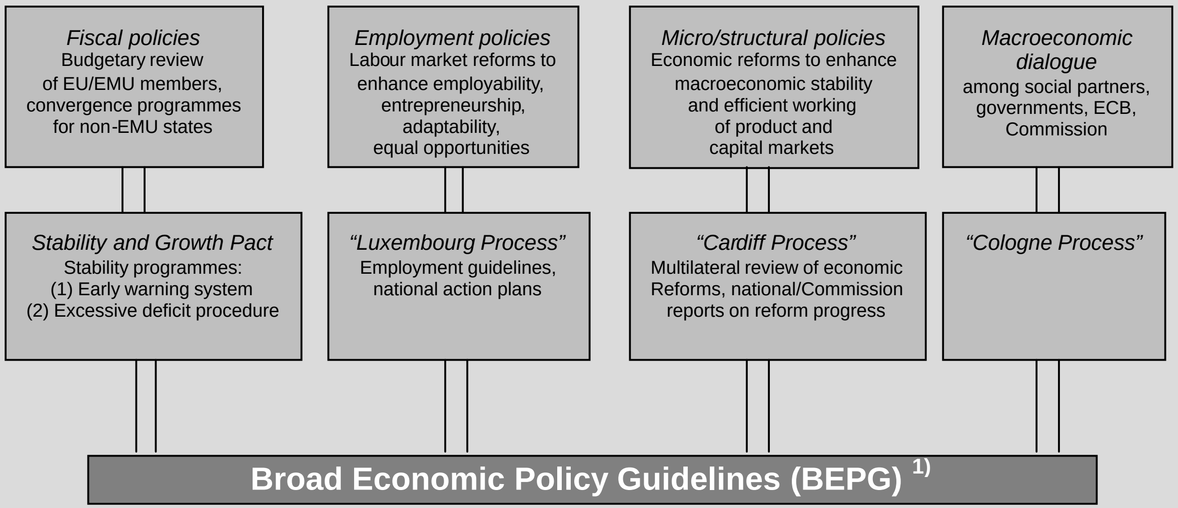
Clearly, endowing the Union with more resources should not lead to an increase in the overall fiscal pressure. The financial framework for the EU for the years 2000 to 2006 were decided in 1999 in Berlin. The framework for the next period 2007 to 2013 is expected to be determined only in

[18] European Commission: Report of the Study Group on the Role of Public Finance in European Integration ("McDougall Report"), Official Publications of the EC, Luxembourg 1977.

2005 or 2006. However, this financial framework cannot be regarded as a multi-annual budget. There is still an annual budgetary procedure for determining the actual level of expenditure under the expenditure ceilings agreed for the financial framework. The Draft Constitution (Part I; Title VII) confirms the following principles:

- The budget of the Union shall be entirely covered by its own resources. In other words, the Union must follow sound, but rigorous, financial discipline.
- The limit of EU's own resources shall be laid down by a European law of the Council. The Council shall act unanimously after consultation of the European Parliament.
- The Union's annual budget is to comply with the multi-annual financial framework.

These arrangements remain particularly restrictive, especially considering the unanimous voting requirement.



[1] The BEPG are adopted annually by the ECOFIN Council as a reference document for the conduct of the whole range of economic policies within the EU. EU Member States regard their economic policies as a matter of common interest and coordinate them in the framework of BEPG.

Source: European Commission