Evolution of EU Economic Governance

Digest of recent developments: 1st semester 2016

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After so much innovation in economic governance since the onset of the Greek crisis in 2009/10, culminating in the implementation from the beginning of 2016 of provisions on dealing with failing banks – an important dimension of banking union – the first half of 2016 has been more routine. It has not been without controversy or incident, but has not seen significant new developments towards completing economic and monetary union, as mapped out in the 2015 Five Presidents' Report. Brexit and the imminence of significant votes in several key Member States manifestly militated against the launching of new initiatives.

Plans to extend banking union through a common European Deposit Insurance Scheme (EDIS) have struggled to make progress and other relatively low-key measures have been stalled. In June 2016, the Council put forward its draft recommendation on the establishment of productivity boards (the Five Presidents' Report had called for 'Competitiveness Councils'). The recommendation is to the euro area countries, but others are encouraged to establish similar bodies with the remit of the boards to be to analyse productivity and competitiveness. Their reports and analyses may feed into EU governance processes, notably the semester and the macroeconomic imbalances procedure and they should be open and transparent in what they do. Although agreement on the recommendation was envisaged at the July 12th ECOFIN Council, it appears not to have occurred.

One recent orientation for policy reform has been the development of a European Pillar of Social Rights, promoted by Jean–Claude Juncker and led on his behalf by Allan Larsson, the charismatic former Director-General of DG Employment and Social Affairs of the Commission. The intention appears to be to show that, after years of austerity as the dominant governance narrative, the EU's leaders and institutions can offer the prospect of more tangible social progress in the EU and, by so doing, to shift the European integration 'project' closer to the concerns of citizens. An outline of what it may contain has been drafted by the Commission, setting out proposals under the three headings of:

- *Equal opportunities and fair access to the labour market*, combining measures to underpin enhanced support for workers with fairness
- *Fair working conditions*, embracing workplace conditions and representation of workers
- *Adequate and sustainable social protection*, covering a range of function of the welfare state

Both the productivity boards and the social pillar remain work in progress. This digest on economic governance therefore looks in more depth than in the first and second UKANDEU digests at selected facets of European economic governance, highlighting the political economy difficulties they evoke. It starts by examining the European semester and the role within it of the country-specific recommendations. The second section reviews the most recent developments in Greece and what they imply. Section three turns to the clash of principles behind many of the disputed areas, especially around risk controlling versus risk sharing. Concluding comments complete the digest.

1 Monitoring and surveillance: the European semester

With hindsight, surveillance of Member State economies by the EU institutions has much to answer for in failing to identify the growing imbalances behind the euro crisis. There have been plenty of analyses since, with some focusing on the role of debt, others on fiscal irresponsibility or the paucity of structural reforms. In response, the EU substantially strengthened its monitoring procedures, establishing an annual governance cycle now commonly referred to as the European semester.

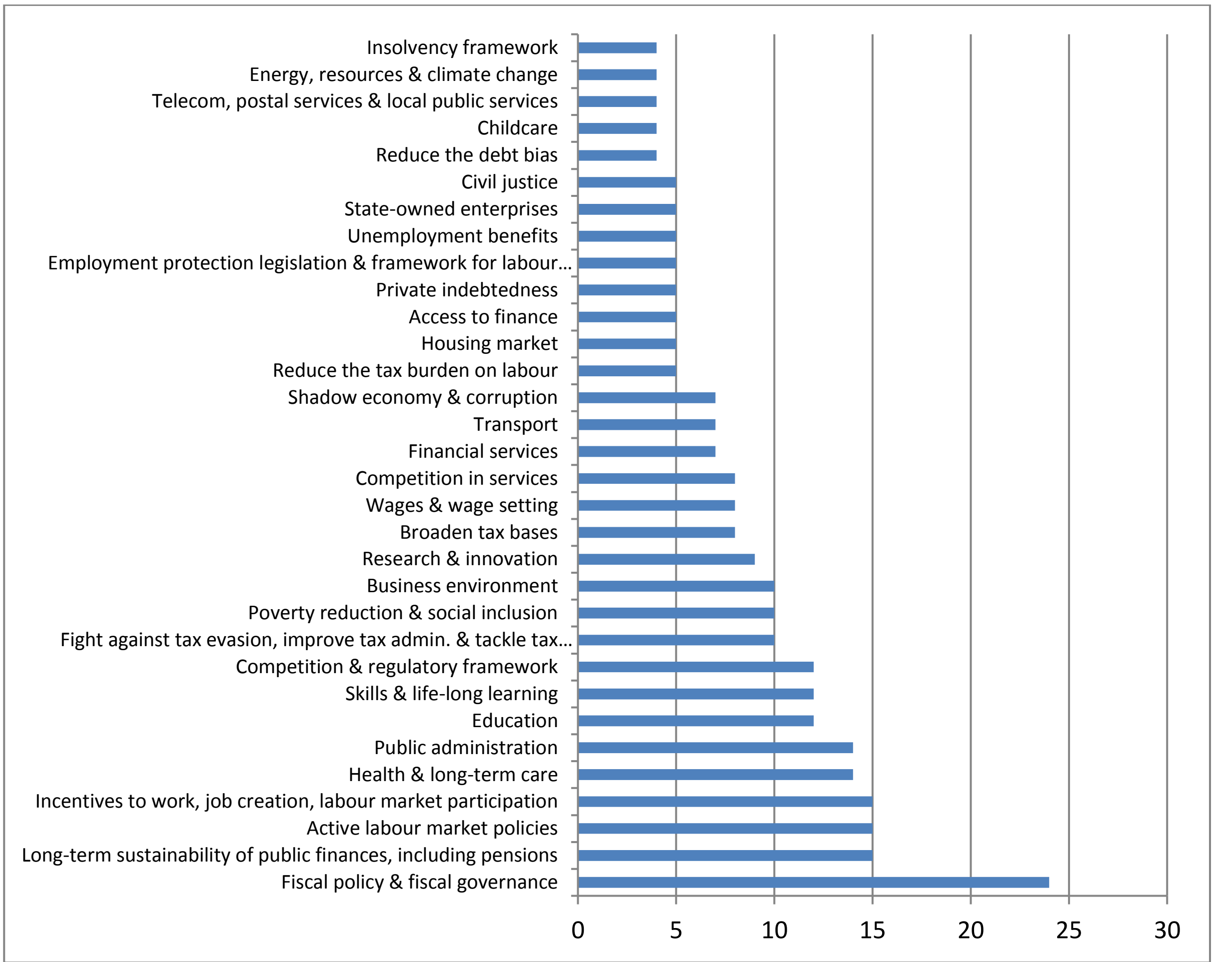
1.1 Country-specific recommendations

In the annual European economic governance cycle, the country-specific recommendations (CSRs) are the opportunity for 'Brussels' to advise national governments on policy priorities for the coming year. It is a mechanism that has been tweaked repeatedly over the years, but has also attracted criticism for being tangential to domestic policy-making. For the 2016 exercise, the Commission announced that the recommendations would be 'streamlined' (best understood to mean 'simplified') and would have 'a stronger focus on employment and social performance, enhanced democratic dialogue, promoting convergence by benchmarking and pursuing best practices'.

The latest clutch of CSRs was published in May 2016 by the Commission and formally approved by the Council on July 12th 2016. In a summary table on CSRs, from which figures 2 and 3 (below) are derived, the Commission lists the policy areas covered in each country in the recommendations. For all but four Member States, the first recommendation concerned the public finances, typically consisting of advice to intensify efforts to push the current budgetary balance towards surplus and to establish a clear pathway towards lower public debt. Other recommendations are much more varied.

An overview presented in Figure 2 confirms that fiscal policy and the sustainability of public finances are the most frequently mentioned, followed by those relating to the labour market. The relatively high number of references to the need for reforms in public administration and countering tax evasion is also noteworthy, as is the fact there are plenty of recommendations on a range of social policies.

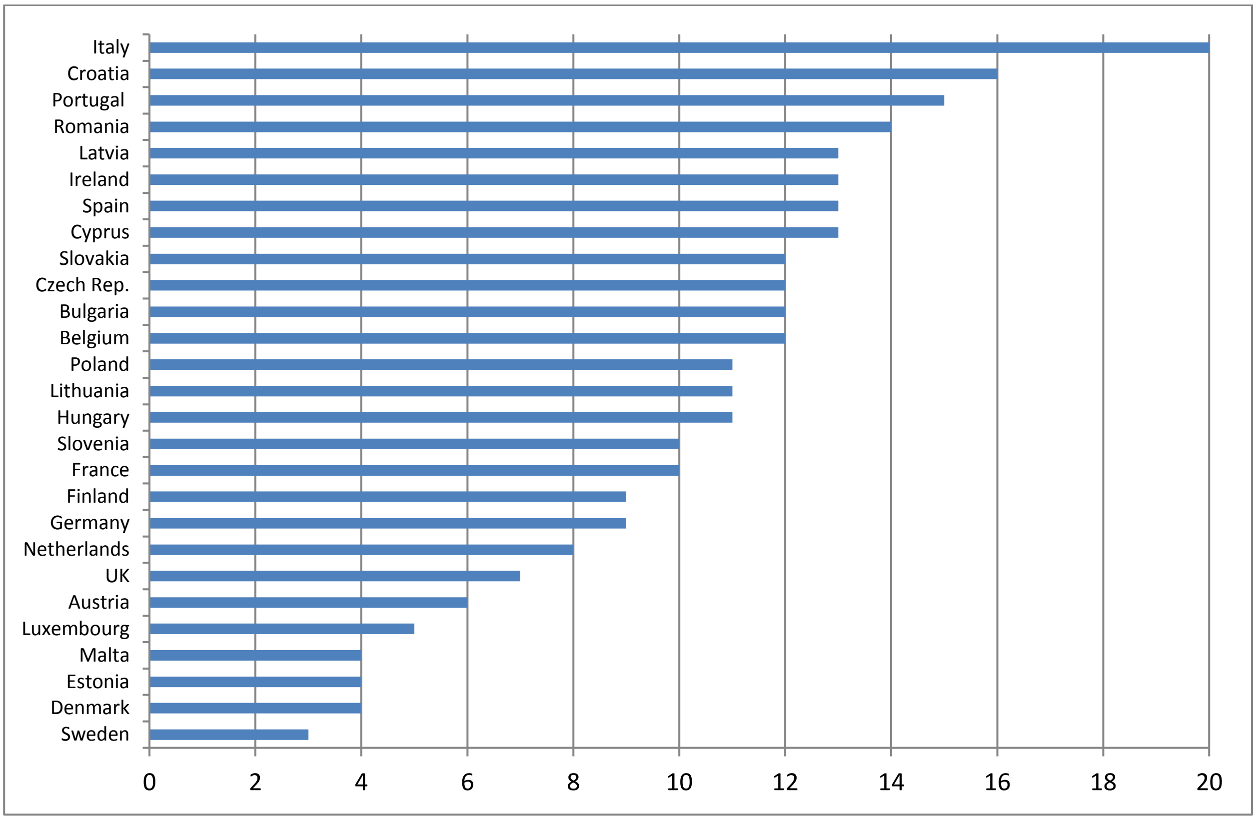
Figure 2 Areas covered in country-specific recommendations, number of mentions all countries



Source: own elaboration from Commission summary table on CSRs

Figure 3 summarises the number of different policy areas by country signalled in the CSRs. Although the number of areas mentioned is, in part, a function of what the Commission considers important, the data suggest the crude, though revealing interpretation that Member States with the most entries in the table have the least satisfactory socio-economic performance, with Italy standing out from the rest. Several of the Member States subject to macroeconomic adjustment programmes are also prominent.

Figure 3 Number of topics covered in country-specific recommendations by Member State



Source: own elaboration from Commission summary table on CSRs

In addition to the CSRs, the Commission published a series of thematic 'fiches' on the main policy areas likely to feature in national reform programmes. These thematic reports are connected to the long-term growth objectives of the Europe 2020 strategy. They provide succinct overviews of progress in twenty-eight policy areas, in many of which a Commission verdict of disappointment is evident, suggesting that the lower visibility of the Europe 2020 strategy in economic governance is having an adverse effect.

Perhaps to avoid any semblance of interference in the referendum, the CSRs for the UK were about as innocuous as could be imagined. In relation to the public finances, the UK was enjoined to 'endeavour to correct the excessive deficit manner in a durable manner by 2016-17' and to continue to adjust in 2017/18. In addition, the advice was to 'address shortfalls in infrastructure investment' and to 'boost housing supply', the latter including implementing reforms of the planning system. In relation to the labour market, the UK is encouraged to address skills mismatches, improve apprenticeships and to make affordable child-care more widely available. As recommendations for the UK, these are both obvious and broadly in line with plans announced by government, so that their value is highly dubious.

Similarly, the bare five lines addressed to Estonia, calling for improved public services and a boost to private research, development and innovation, are unlikely to give its policymakers sleepless nights, nor are the very general and bland five lines of advice for Denmark. For certain other countries the CSRs are more extensive and detailed, but even so there must be doubts about what they can hope to achieve.

1.2 Budget scrutiny

Since 2013, another governance innovation has been the obligation for Eurozone countries to submit draft budgets in advance of adoption for scrutiny by the Commission. The aim is to identify risks of non-compliance with the Stability and Growth Pact (SGP) and thus to give the Member State the opportunity to revise its plans. As figure 1 shows, only a handful of Member States has been deemed compliant and there is a persistent risk of non-compliance. Moreover, in July, the Council of Ministers deemed Portugal and Span to have done too little to redress their excessive deficits, a finding that should have triggered financial penalties under the SGP.

However, the EU institutions subsequently demurred: as the headline of a press release from the Council of Ministers put it on the 8th of August 2016, the 'Council agrees to zero fines and new deadlines for Portugal and Spain'. In effect, this meant that, at the first time of asking, political imperatives over-rode the carefully crafted new rules. Both countries were also spared a suspension of all or part of their entitlements to receipts from the EU's Structural and Investment Funds. As in 2003, when financial sanctions were not used against France and Germany, resort to fines has proved to be a step too far for Europe's leaders, prompting the question of whether they can ever be credible as instruments to deter fiscal excesses.

Figure 1 Commission assessments of budgetary plans

Year / Assessment	2013	2014	2015
'Compliant'	DE, EE	DE, IE, LU, NL, SK	DE, EE, LU, NL, SK
'Broadly compliant' (or 'no margin for slippage' – a category only used in 2013)	BE, FR, NL, AT, SI, SK	EE, LV, SI, FI	BE, IE, FR, LV, MT, SI, FI
At risk of non-compliance	ES, IT, LU, MT, SU	BE, ES, FR, IT, MT, AT, PT	ES, IT, LT, AT, PT
In macroeconomic adjustment programme	EL, IE, CY, PT	EL, CY	EL, CY
Not then in Eurozone	LV, LT	LT	

Source: Own elaboration from Commission reports
Key: red text is a deterioration from the previous year; green is an improvement

1.3 Assessment

An analysis of the CSRs by Gros and Alcidi finds that implementation is patchy and that it tends to be stronger in smaller Member States than in larger ones, implying (because of the weight of the larger economies) an aggregate effect lower than it could be. They argue that in a period when crisis-induced pressures to reform have abated, the rationale for EU level coordination is weaker, and that the motivation to implement will diminish as economic recovery strengthens. Citing examples from Germany and Italy, they also note that broadly the same recommendations can be made in successive years with no apparent means for the EU institutions to influence progress.

The limited resonance or translation into national policy debate of CSRs raises a number of political economy issues. Peer pressure, which might be a means of strengthening the incentives to follow CSRs, is adjudged by Gros and Alcidi to have had little impact. They speculate that the explanation is a combination of lacking the analytic capacity to assess what others do and not wanting to be seen to be critical of EU partners who might subsequently retaliate.

Positive incentives, notably supportive funds, are lacking and the limited funds hypothecated from the EU's Cohesion Policy budget have too little flexibility to be used to reward the good performers. Nor is there an evident institutional actor at EU or Eurozone level with the true authority to play the 'bad cop' by castigating countries with poor implementation records. Behind such considerations, there is also often ambivalence about whether what the Commission proposes is analytically robust, partly because the implicit reform model is not known and can be perceived (perhaps unfairly) as being a one-size-fits-all formula. Why, in short, should national actors accept the CSRs?

2 Greece, once again…

Although Greece has been lower profile than in the first half of 2015, after Syriza came to power, tensions remain and there was yet another difficult period before the latest tranche of the bailout funds was released in May. There was friction, notably, between Germany and the IMF over whether or not to write-off Greek debt. After some further brinkmanship, Greece did obtain the next tranche of funding, while a compromise of sorts was agreed between the EU and the IMF to keep the latter involved in the Greek programme on the understanding that debt relief would be looked at afresh in 2018. In a blunt assessment, Daniel Gros has argued that there is no longer a compelling case for keeping the IMF on-board, because it charges much higher rates than Greece's EU partners, something that is also costing the taxpayers of Ireland and Portugal more than they need pay.

Former senior Commission official Fabio Colasanti argues in a carefully documented paper that there are many misconceptions about the unfolding Greek crisis and the country's debt dynamics. In particular, he debunks the often heard idea that the money from successive bailouts went predominantly to creditor country banks. He also notes that the lengthening of maturities and the lowering of interest rates effectively reduced the value of Greek debt – a hidden write-off. The upshot is the convenient fiction that Greek debt is still worth its nominal value, even though economically it is devalued.

Restructuring debt in this way, Colasanti argues, made sense because the conventions on public accounting mean a formal write-down of debt would have knock-on effects on the debt positions of those who now own Greek debt. They comprise other Member States, both directly though bilateral loans and indirectly through entities they underwrite such as the European Stability Mechanism, and the IMF, while the ECB is involved through its purchases of sovereign bonds from the banking sector. Among the many paradoxes around the euro crisis, one highlighted by Colasanti is 'the criticism that too much money has gone to the banks very often originates from the same people who in 2010 requested an intervention "to save Greece", or in other words, an intervention to prevent a default'.

3 Risk-controlling or risk-sharing?

Although few would now argue that the euro is still in danger of collapse, the entire saga has exposed deep divisions in what different Member States and other actors consider necessary to complete EMU. A dilemma at the heart of much of the unfinished business in European economic governance is whether, and in what sequence, measures aimed at reducing and controlling risk should be favoured over those that would enable risks to be shared. Debt mutualisation, flexibility in fiscal rules, the provision of a common fiscal 'backstop' to assist countries facing financing difficulties, proposals for even a limited EU (or Eurozone) level fiscal stabilisation capacity and completion of banking union can all be seen through this lens – see, for example, the analysis by the House of Lords European Committee.

The nub of the debate is trust. At its simplest, creditor countries or those that subscribe most strongly to rule-based policy-making, believe that making it easier for 'delinquent' countries to shift some of the risk they face will weaken their incentives to implement changes likely to prevent risks. In essence, this is a moral hazard argument. Advocates of risk-sharing, by contrast, believe that the mere existence of supportive mechanisms will enable them more easily to deal with the challenges, ultimately benefitting all sides. They argue, further, that some of the reforms they identify as needed (or are pushed into through

EU governance processes) are costly and take time, and are more likely to succeed if they can be underwritten by risk sharing, even if no hard cash has to be transferred. The ideal sequencing is disputed and the differing standpoints are difficult to reconcile, as is evident from the stalemate on several of the Five Presidents' proposals.

3.1 Full banking union…or not?

Finding the appropriate sequence is central to arriving at a solution to the thorny issue of how to complete banking union. Although some commentators question the need for common deposit insurance, there is a compelling logic to complementing EU level supervision and resolution with EU level insurance. Moreover, complete banking union will require an EU level fiscal backstop to provide for instances when even a common insurance fund does not have sufficient resources to cope with a major systemic event. What should be stressed is that such a backstop would rarely, if at all, be used and that it could not be a blank cheque for bankers who take excessive risks.

Yet according to a 'non-paper' from the German government, the imperative is breaking the 'doom-loop' between banks and sovereigns. This should by achieved, first, by stronger prudential supervision and effective mechanisms for resolving failing banks, but also be reducing the exposure of banks to sovereign risks. Only then can steps to introduce common deposit insurance be considered. By contrast, those who want to find ways of sharing risk believe that failure to do so could lead to a vicious cycle of worsening problems.

Despite the best efforts of the Dutch Presidency in the first semester of 2016, little tangible progress has been made on taking forward the proposals for EDIS. However, there has been a good start on funding the single resolution fund established as part of the agreement on how to deal with failing banks. Moreover, by the start of the Slovak Presidency at the beginning of July 2016, eleven of the nineteen Eurozone Member States had signed an agreement to provide bridging finance for the Single Resolution Fund – something canvassed in the Five Presidents' Report to enable the Fund to deal with any immediate challenges before it is able to build up to its full size by 2025.

The two sides of the sharing versus controlling dilemma are becoming visible in the problems now confronting the Italian banking system, beset by a high incidence of non-performing loans, with one of its biggest banks, Banca Monte dei Paschi di Siena (MPS) especially exposed. According to the rules on bank resolution adopted in recent years, the solution is to 'bail-in' depositors before making any calls on tax-payers. However, the Italian government was anxious to avoid doing so because of concerns about the time it would take and because the latest round of stress tests conducted by the European Banking Authority at the end of July 2016 highlighted difficulties in MPS and other Italian banks. To the extent that it would flout the rules, the proposed action would have put the Italian government on a collision course with the EU institutions and a number of other Member States, but at the eleventh hour a solution was found to hive off MPS's bad loans to a 'bad bank' and for a recapitalisation to be underwritten by a number of foreign banks.

3.2 A new fiscal capacity as risk sharing?

A second example of risk sharing would be an additional fiscal capacity at the EU or, more immediately, Eurozone level. Objections to it start, as so often, with moral hazard arguments against rewarding those considered to be fiscally irresponsible. Fiscal risk-sharing is, however, a standard and largely uncontested feature of national polities and the very substantial net flows among regions play a large part in mitigating localised economic fluctuations. Yet extending this reasoning to the EU or even the Eurozone comes up against objections that pit economic logic against political acceptability. For the time-being, therefore, more elaborate forms of fiscal risk-sharing remain off the agenda, and seem unlikely to return to it over the next year, with major elections in France and Germany, plus a referendum in Italy later in 2016, casting an especially dark shadow.

One specific proposal, namely to create a European unemployment insurance fund, has now been extensively studied – see for example work for the European Parliament and a study for the Commission by CEPS – but looks as though it is falling on stony ground, despite attracting support from Italy and some members of the European Parliament. The principle is pretty straightforward: if unemployment in a country suddenly worsens compared with an agreed benchmark, the country would be eligible for a payment from the fund, but would pay back into the fund when its unemployment rate fell below the threshold. There are obvious challenges of detail about how to set the benchmarks, how long any support would last and the conditions to be imposed. In some countries, high unemployment is, in part, the result of spatial or other imbalances in the economy (structural unemployment).

4 Concluding comments

EU economic governance is in something of a quandary. As the Four and Five Presidents' Reports spell out, shortcomings and gaps in the governance of EMU persist and failure to address them will leave the Eurozone (especially) vulnerable to renewed episodes of instability. Without further developments, the European financial area will still be subject to national risks, with two implications. First, contagion would remain a possibility, because the inability of one country to cope would (unless banking systems retreat fully behind national borders) still spill over to others. Second, differences in national arrangements would undermine the integrity of the single European market for banking (and possibly other financial services) and place banks in some countries at a competitive disadvantage. The latter effect may, in addition, have adverse effects on the cost and availability of credit in the Member States most in need of a boost for their small businesses.

Yet although many credible solutions have been put forward, there is an evident reluctance to adopt some of the measures intended to bolster EMU governance, even where the weight of opinion – certainly among academics and think-tankers – is that they are needed. In earlier stages of the euro crisis, a metaphor often used was 'kicking the can down the road', implying indecision or procrastination prompted by concerns about how burdens would be shared, rather than an inability to find solutions. Now, however, the incompatibility of the conflicting positions has become much more pernicious.

Finding the right balance between risk-controlling and risk-sharing will be crucial if this deadlock is to be broken. But so, too, will be connecting better with citizens. In this regard, the results of the referenda this year in the UK and in the Netherlands, as well as in Greece in July 2015, have to be understood as more than protests from those seeing themselves as losers from either globalisation or a process of integration in Europe that has gone too far. Together with the rise of populist movements in so many countries, they also signal that trust in elites, technocrats and experts has become badly eroded. Social Europe, as an answer, sounds appealing, but is prone to be more slogan than reality. For Europe's leaders, developing more effective economic governance is likely to be a litmus test of their credibility.

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