

EUROPEAN POLICY BRIEF



Reconciling the short and the long run: governance reforms to solve the crisis and beyond

Karl Aiginger (WIFO), Olaf Cramme (Policy Network), Stefan Ederer (WIFO), Roger Liddle (Policy Network), Renaud Thillaye (Policy Network)

Reviewed by Kurt Bayer (EBRD)

Policy Brief No. 1

September 2012

INTRODUCTION

Objectives of the research

More than two years after the start of the Greek debt crisis, the future of the European Monetary Union (EMU) still looks uncertain. Despite numerous changes in economic governance, Europe has failed to reverse the momentum of bond market uncertainties. The economic and political damage is already considerable with the economy being dragged into recession, soaring unemployment and mounting euro scepticism.

This policy brief is the first outcome of a four-year project which started in April 2012 and aims at providing the analytical basis for a new European growth path towards a socio-ecological transition. Reforming European governance is one of the five main topics of the project. The policy brief starts by highlighting the economic blind spots in the EMU's governance framework and its reforms and sheds light on the resulting political dilemmas and tensions. It then contrasts the current "insurance-adjustment" strategy, based on conditional solidarity and market-based adjustment, with the design of a more robust and sustainable governance framework. It argues that a crisis management based on short-run measures will only be successful if European leaders simultaneously provide a long-term vision for the European Union (EU) and cope with the political tensions which have grown out of the crisis. This vision has to be built around the key elements of an economically dynamic, socially inclusive and ecologically sustainable Europe. It should paint a clear picture of where the EU wants to be in 2020 and beyond, namely a Europe which:

- aims at attaining a higher quality of life and social inclusion for its citizens (including reducing unemployment and particularly youth unemployment);
- is driven by innovation and strong human capital;

- employs an ecologically sustainable and financially more stable production model;
- respects heterogeneity but reduces welfare gaps across countries and individuals;
- improves the European model and strengthens Europe's position in world markets and institutions.

Building on this analysis, the policy brief provides recommendations for policymakers to overcome the pitfalls of the current crisis management and to sketch the parameters of a more sustainable union. These measures however, require more than governance reforms alone, and they will not be easy to achieve. Consequently, particular attention is paid to the policy and political dilemmas that have emerged throughout the crisis: the clash between adjustment, social cohesion and long-term investment; the challenge of finding a *modus vivendi* between a more integrated Eurozone with a Community-based EU 27; the demands for more sovereignty and more democracy. A lot can be done on the economic front within months in order to contain the crisis, restart growth and to make the European economy more stable. However, short-term measures need to be in accordance with the transition towards a new development model and to be consistent with the long-term vision of a workable and legitimate EU.

This policy brief primarily focuses on economic questions. The governance reforms necessary to embark on a socio-ecological transition will be elaborated in more detail in the course of the project.

KEY OBSERVATIONS

The blind spots in EU economic governance

The original set-up of EMU proved incapable of ensuring long-term stability in a non-optimal currency union, specifically in the aftermath of the financial crisis. The principle causes of EMU's instability are the following:

- The hope that monetary union would by itself spur convergence, turned out to be overly optimistic.
- The single monetary policy was not adequate for both core and periphery countries and had asymmetric pro-cyclical effects.
- Insufficient macroeconomic coordination and misaligned wage and productivity developments translated into significant competitiveness divergences with high deficits in current accounts in some countries and high surpluses in others.
- Fiscal rules could not prevent deficits and debt from being too high in "good times" and rising dramatically during the crisis.
- The risk of sovereign default of individual member states was neglected (despite the no-bail out clause). The misperception of risks by financial investors allowed inappropriately low interest rates to develop in some countries. This in turn fuelled credit-driven demand and asset price bubbles.
- The abrupt change in the perception in the aftermath of the financial crisis brought about serious problems of refinancing

for governments.

- The absence of a lender of last resort for states resulted in a self-reinforcing fiscal crisis.
- Decentralised, diverse and insufficient banking regulation and a lack of trust and transparency led to a fragmentation of financial markets during the crisis and a fatal link between states' and banks' solvency.
- Fiscal rescue measures have taken precedence over broader socio-economic goals as set out in the Europe 2020 targets.

A plethora of significant and far-ranging reforms carried out over the last three years aimed to strengthen EMU governance. They have kept the Euro afloat and the Euro area in one piece, avoiding the alternative scenario of a break-up, competitive devaluations and protectionist national responses.

But they did not alleviate the concerns of financial investors about EMU's sustainability. The pressure on deficit countries remains extremely high, with their economies in recession and unemployment reaching record levels. Excessive austerity without being counterbalanced by growth and employment measures threatens to damage social and political cohesion as well as the economic prospects of future generations. The failure to provide a long-run vision for EMU severely undermines political support in both creditor and debtor countries.

Economic deficiencies

Limited monetary bridging

In the face of increasing instabilities in the financial system, the European Central Bank (ECB) has taken on much broader responsibilities than originally foreseen, both towards banks (Long Term Refinancing Operation) and sovereigns (Securities Market Programmes and, most recently, Outright Monetary Transactions). Yet, these moves have met criticism. Interventions therefore have, for too long, been unsystematic and have not sustainably reduced interest rates.

The European Stability Mechanism (ESM), which is taking over from the temporary European Financial Stability Facility (EFSF), is intended to ease the burden on the central bank and maintain the separation of fiscal and monetary policy. It indicates a step forward in acknowledging the need for a permanent collective umbrella in the EMU. However, the limitation of its resources impedes its ability to have a significant impact.

The June 2012 EU Summit sowed the seeds of a banking union by granting to the ECB the status of supervisor for (at least the large) banks within EMU and foreseeing the direct recapitalisation of banks by the ESM. The EMU is, however, still far away from being a banking union: there is no European deposit insurance and no bank resolution scheme to enable taking cross-border risks into account.

A tightened but still imperfect regime of fiscal surveillance

The "Six Pack" reforms adopted in October 2011 beefed up the Stability and Growth Pact. National budgets will be examined earlier and closer by the European Commission. An Excessive Deficit Procedure (EDP) can now be triggered against a member state whose debt ratio is not coming down quickly enough. Sanctions against member states under EDP can be adopted on the Commission's proposal except if a "reverse majority" opposes it.

The Treaty on Stability, Coordination and Governance (TSCG) signed by 25 EU member states sets a new cap on structural deficits. Member states must implement a "debt brake" into national law lest they risk being sued by one or several others in the European Court of Justice.

Fiscal rules and procedures however, though substantially tightened, will continue to produce suboptimal results:

- For some countries, fiscal targets are not realistic under current circumstances and will most probably be breached.
- Tighter fiscal rules will shift the priorities even further away from Europe 2020 targets.
- "Collective austerity" hampers growth and investment in EMU, thus making compliance with rules even harder.
- The focus on fiscal adjustment and structural reforms will not enable the easy achievement of debt sustainability in deficit countries. The toxic combination of potentially spiralling interest rates, negative growth and rising unemployment persists.
- The new institutions will increase fiscal discipline in the future. Without additional growth supporting measures they will probably not prevent further self-fulfilling fiscal liquidity crises. The risk of contagion remains.
- The "reverse majority" leaves the problem of "unenforceable" fiscal rules unresolved for large member states.

Macroeconomic coordination with a strong disciplinary bias

A new Macroeconomic Imbalance Procedure (MIP) is now in place with the objective of preventing and correcting divergences in competitiveness. On an intergovernmental basis, the Euro-Plus-Pact pursues the same objectives. Member states' commitments are to be inserted into National Reform and Stability and Convergence Programmes.

The disciplinary approach to macroeconomic coordination, while to some extent inevitable, produces costly externalities:

- Corrective measures put a heavier burden on deficit than on surplus countries and are likely to increase divergences in living standards in the short and medium run.
- There is no automatic mechanism which would supplement monetary policy and counteract its asymmetric effects.
- Although the Euro-Plus-Pact contains a number of provisions to increase productivity and employment, it must also ensure

that the strong focus on price competitiveness and wage restraint does not suppress demand in the whole EU.

- The narrow focus on cost-competitiveness over qualitative aspects of competitiveness in practice disregards the need to improve education, training, research and innovation, thereby damaging economic prospects in the long run.

Political trade-offs

Adjustment vs. cohesion and diversity

European integration has long been seen as a convergence success story. Community institutions have generally tried to accommodate the socio-economic diversity of member states. Social models have remained a national competence.

The launch of EMU unsettled this consensual approach by pushing for market-based adjustment and interpreting policy convergence in a narrow frame (Maastricht criteria). The recent reforms of EU economic governance have reinforced this logic. Structural reforms implicit in the MIP and the Euro-Plus-Pact overwhelmingly impose downward social pressures, if not complemented by compensatory measures such as the retraining and reintegration of the unemployed.

The prevailing preference for market flexibility and fiscal discipline, together with a lack of focus on employability, job creation and security for the weakest members of society and the young, might thus prove politically divisive if the results leave behind some groups of member states and citizens.

Eurozone's requirements vs. Community method

Recent governance changes in EMU have produced a blurry picture of technocracy and intergovernmentalism. The crisis has seen a growing lack of trust in the Community method. The ESM treaty only gives a consultative role to the European Commission. The European Parliament is largely sidelined from the European Semester. The pivotal role of the European Council in designing an inter-state insurance system and in deciding on its use gives the impression of an EU governed by EMU's biggest countries.

This new institutional balance is further complicated by the unsolved and unclear relationship between the EU 27 and the developing EMU institutions. Further integration in EMU will raise these tensions even more. Ad-hoc measures increase the tendency of the decision-making system to become more complex and difficult to manage. Intergovernmental arrangements will possibly interfere with Community institutions. The integrity of the Single Market could be damaged by specific regulatory arrangements necessary to coordinate policy in EMU. Any deeper integration can create stress between Euro-ins and Euro-outs.

Crisis resolution vs. democratic politics

Crisis politics has triggered widespread discontent over the road embarked upon by the EU and its member states. At policy level, the decision to bail out countries and to impose structural adjustment programmes on them has pitted creditors and debtors in opposition to each other. At constitutional level, some measures may also be regarded as being in potential conflict with EU treaties and national law. The decision-making system has become more complex in the public's perception and its accountability less clear. Anti-EU populist parties are on the rise. This background of weak legitimacy represents a huge obstacle to laying the ground for more sustainable governance in the EU. A weak sense of identification with Europe and of Europe-wide solidarity runs counter the logic of deeper integration.

Crisis resolution strategies: reconciling the short and the long run

The need for further changes in EU governance to restore stability is widely accepted. A break-up of EMU would trigger enormous economic and political costs. The option of a smaller and more optimal monetary union is therefore not considered here. The exit of a member state might happen as a consequence of crisis mismanagement or national choice; but EU leaders should not make it a strategic option.

In the short run, a more assertive response is needed to overcome the immediate crisis and get Europe back on the track of growth. This, however, will not be sufficient: for the measures to be credible to financial markets and supported by the public, European leaders have to provide a long-run vision of a stable EU that guarantees high employment and well-being. To achieve this, the shortcomings of the EMU have to be addressed and corrected.

The insurance-adjustment strategy needs to be bolstered in the short run

Short-term stabilisation requires improving the double track of insurance and adjustment which has characterised EMU crisis resolution for the last two years. On the insurance side, central institutions need to counterbalance the different positions of member states. On the adjustment side, symmetrical and joint efforts are necessary to facilitate a return to a stable growth path. The strategy requires measures which tackle the following key issues:

- Reducing interest rates for deficit countries and thereby giving governments more time to implement reforms.
- Creating incentives for deficit countries to carry through painful adjustments by minimising their social implications (e.g. greater share of EU funds and EIB project bonds for social and ecological projects and business start-ups).
- Restarting growth so as to make deficit and debt reduction possible without lethal economic and social damage.
- Improving competitiveness and reducing imbalances without creating deflation in any EMU country.

The beefed up insurance adjustment strategy implies a greater extent of burden-sharing, at least temporarily. Member states would have to increase their contribution to the ESM and extend their joint guarantees for public debt. Surplus countries would have to brace themselves for potential financial losses. Reducing imbalances requires higher demand in surplus countries. Stimulating growth at national and EU level would necessitate changes in the structure of taxes and expenditures.

Most of these measures can be taken without any changes in EU Treaties. Policy innovations, such as (i) stimulating demand in surplus countries (ii) technology transfers so as to boost productivity in deficit countries (iii) reducing income inequalities so as to stimulate consumption (iv) accepting divergent target inflation rates still leave some policy space for this strategy. However, the mood in surplus countries is very much opposed to supporting deficit countries (either by transfers or by stimulating their own domestic demand).

Crisis management needs to be anchored in a long-term vision

A long-run strategy needs to address the flaws of European integration. Even more importantly, it has to build on a vision for Europe to be convincing and get the necessary political support. As laid out in the introduction, this vision should not only be based on the Europe 2020 targets of a smart, sustainable and inclusive economy; it should also be in line with a new development strategy which enables a socio-ecological transition to high levels of employment, social inclusion, gender equality and environmental sustainability, taking into account the dynamics of an ageing society in a globalised world.

The elements of a long-run strategy follow directly from the problems inherent in the present design, which have surfaced in the last decade:

- Instruments of debt mutualisation, such as EMU bonds up to a certain limit, create a large and liquid market of low-risk assets and provide sustainable financing cost for public investment.
- A lender of last resort for governments prevents self-fulfilling liquidity crises in EMU member states.
- A banking union comprising a central regulator and an EMU-wide resolution fund breaks the link between the twin exposure to indebtedness of banks and sovereigns: furthermore, it prevents the fragmentation of financial markets.
- A limited transfer of fiscal sovereignty to a central authority reduces the possibility of free-riding by individual member states.
- A debt restructuring scheme for insolvent governments clarifies the course of action and the risks for investors *ex-ante*.
- An automatic transfer regime cushions asymmetric shocks and smoothes cycle divergences within the EMU.

Risk-sharing is an important element in this strategy. Debt mutualisation would probably raise the borrowing costs of surplus countries,

but as the introduction of EMU shows, the upward shift for surplus countries might be small. A banking union and an automatic stabilisation mechanism might turn into a regime of permanent redistribution from creditor to debtor countries if imbalances are not contained.

Such a strategy faces formidable political challenges. Opinion surveys show that the majority of European citizens are fiercely opposed to any form of fiscal centralisation. A common vision must therefore reconcile the conflicting demands for more democracy and more sovereignty which currently prevail across Europe. Ignoring these political dynamics will only create further eurosceptic backlashes and ultimately lead to Europe's undoing.

RECOMMENDATIONS

Balancing adjustment, cohesion and long-term investment

Short- and medium-term action is needed to address the immediate problems. Many measures can be taken without any changes in the EU Treaties. Some of them could be implemented only temporarily. Nevertheless, they require taking into account political obstacles, interdependencies and sequencing; they also need to be consistent with a long-run vision of where Europe wants to be in 2020 and beyond.

To address the most pressing fiscal problems:

- Extend deadlines for fiscal consolidation and implement discretionary measures in deficit countries to stabilise the economy while keeping the medium-term commitment to balance public finances.
- Create a temporary, limited but extensive debt-redemption fund; alternatively, bolster up the ESM and use it to buy government bonds directly in primary markets.
- Consider writing off part of the debt of the most fragile countries.

To overcome the financial crisis and appease the markets:

- Encourage the ECB to limit the spread of interest rates as a permanent part of its policy. Assess bank solvency on a system-wide basis and resolve insolvent banks.
- Give the ESM temporarily the ability to recapitalise banks and assume ownership as well as the ability to guarantee deposits.
- Assess and restructure EMU's banking system from a pan-European viewpoint; address the number and size of banks, their risk-bearing capacity and the separation of commercial and investment banking.

To stimulate growth and employment:

- Use all available funds at EU level to support long-term growth in deficit countries and set mandatory targets for their use (as closely monitored as the budget reduction goals). Specifically, use funds for promoting jobs and business start-ups in countries with high youth unemployment.
- Create positive economic spill-over effects from surplus

countries to deficit countries by increasing wages at least as fast as productivity, reducing spreads in personal incomes and utilising the fiscal space for ecological investments.

- Increase EU funds in the 2014-2020 Multiannual Financial Framework, provided that the European Commission is mandated to radically rethink the present budget design so that it prioritises policies supporting sustainable growth, innovation and employment.
- At national level, lay the potential for stronger growth in the medium-run by implementing structural measures which do not impair budget balances. This implies removing barriers for investment and business start-ups, switching government expenditures from bureaucracy and military spending to training for the unemployed, work benefits for young people and switching from labour related taxes to resources and property based taxes.
- Implement a Financial Transactions Tax at EMU level so as to increase resources for growth-enhancing measures in the short-run and reduce taxes on business and labour in the long-run; distribute more equally the burden between financial markets and taxpayers. Fight tax evasion and monitor offshores and "non banks" more effectively.

To improve social cohesion:

- Advance the European socio-economic model which combines market flexibility with social protection, acknowledging differences in speed and priorities across countries and benchmarking success.
- Coordinate tax, wage and social policies in order to improve symmetrical adjustment in EMU; this could be done through a "Social Pact". Take matters of distribution (wage share and dispersion) into account in the Macroeconomic Imbalance Procedure.

To move towards a stronger EMU:

- Establish a common and positive vision of what governance reforms in the EU can achieve in the long run. The basic elements of this vision should be an economically dynamic, socially inclusive and ecologically sustainable Europe.
- Prioritise Europe 2020 objectives and National Reform Programmes over the Stability and Growth Pact in order to encourage long-term social and ecological investment, avoid deterioration in human capital and make Europe a leader in environmental technologies.
- Establish a banking union, institutionalised by means of EMU bank supervision, a resolution agency and a deposit guarantee at EU level. Discuss the "too big to fail" problem and further measures so that the financial sector, including offshores, does not destabilise the economy.
- Define the extent of permanent debt mutualisation and link this to the discussion on the transfer of fiscal sovereignty to the EU level.
- Implement a regime of automatic transfers in EMU to tame divergent cyclical positions and make adjustments smoother

(e.g. a union-wide unemployment insurance with some national obligations remaining to prevent moral hazard). This regime could be established outside the EU budget in a transfer fund which would be balanced over the business cycle.

- Start a discussion process on whether to change the ECB's mandate by adding employment as another statutory goal along with price stability. This would bring the ECB in line with the US-Fed. This should be done in a way that does not question the main responsibility of governments and the European Commission in tackling unemployment.

Fine-tuning the relationship between EMU and EU 27

The balance between necessities of EMU governance and the economic and political integrity of the EU as a whole needs to be sustained throughout the reform process. To achieve this:

- Embed any move towards deeper integration in the Community framework. Extending the scope of enhanced cooperation would be the ideal vehicle for EMU-specific governance.
- Intergovernmental treaties should be avoided for the risk of balance-of-power politics and institutional redundancy.
- Assign a greater role to the European Commission in EMU issues.
- Start a discussion process about creating a second chamber ("Euro Chamber") bringing together European and national parliamentarians from EMU (and "pre-in") countries and integrate this potential second chamber firmly in the decision-making of the ESM and other related Euro area matters.

Reconciling EMU governance with democratic politics

EU governing institutions need to become more responsive to EU citizens' interests and policy preferences:

- Enhance politicisation at the EU level. The 2014 European election will be a step in this direction: it will for the first time see the fielding of opposing candidates to the Commission's presidency. Furthermore, the President of the Commission could be elected directly by EU citizens.
- Integrate national parliaments better into the decision-making processes at EU level, both by sending representatives into a second Euro Chamber and by extending the power of committees in EU affairs.
- Engage citizens in an honest debate about the fast-changing developments and decisions of EU economic governance.
- Prepare for a consultative process which gives citizens a more explicit role on the path towards deeper European integration.

The five-fold goal of a new European governance

Governance reforms in the Eurozone urgently need in the short run to provide institutions solving the crisis. In the long run they have to be reconnected to an ambitious long-term strategy for Europe with the objective of:

- Increasing sustainable growth and employment.
- Improving the stability and resilience of the economy.

- Closing the gaps in productivity, wages, equality and wealth.
- Closing existing and preventing new disequilibria in budgets and current accounts.
- Promoting transition to a more smart, sustainable and inclusive "European Model".

Several recommendations, specifically those on the long-run transition require further research. The project WWWforEurope will support the reform processes with in-depth analyses. It should also be accompanied by a broad discussion with European citizens.

ACKNOWLEDGEMENT

We thank Fritz Breuss, Georg Busch, Barry Eichengreen, Heinz Handler, Helmut Kramer, Thomas Leoni, Seamus Nevin, Gunther Tichy and Reinhilde Veugelers for valuable comments. The responsibility for the content remains with the authors.

RESEARCH PARAMETERS

Objective of the research

In the face of the financial and economic crisis and long-term challenges from globalisation, demographic shifts, climate change and new technologies, Europe needs to redefine its development strategy. The objective of WWWforEurope – Welfare, Wealth and Work for Europe – is to strengthen the analytical foundation of this strategy. It goes beyond the Europe 2020 targets of smart, sustainable and inclusive growth and lays the basis for a socio-ecologic transition. The new development strategy aims at high levels of employment, social inclusion, gender equity and environmental sustainability.

The research programme

WWWforEurope will address essential questions in areas of research that reflect vital fields for policy action to implement a socio-ecological transition:

- It will deal with challenges for the European welfare state, exploring the influence of globalisation, demography, new technologies and post-industrialisation on welfare state structures.
- It will analyse the impact of striving towards environmental sustainability on growth and employment and provide evidence for designing policies aimed at minimising the conflict between employment, equity and sustainability. This involves using welfare indicators beyond traditional GDP measures.
- It will investigate the role that research and innovation as well as industrial and innovation policies can play as drivers for change by shaping the innovation system and the production structure.
- It will focus on governance structures and institutions at the European level and the need for adjustments to be consistent with a new path of smart, sustainable and inclusive growth.
- It will explore the role of the regions in the socio-ecological transition taking into account institutional preconditions, regional labour markets and cultural diversity and examining the transitional dynamics of European regional policy.

This research will be conducted within a coherent framework which from the outset considers linkages between research topics and highlights how different policy instruments work together. The results of all research areas will be bound together to identify potential synergies, conflicts and trade-offs, as a starting-point for the development of a coherent strategy for a socio-ecological transition.

Methodology

The project builds on interdisciplinary and methodological variety, comprising qualitative and quantitative methods, surveys and econometrics, models and case studies.

PROJECT IDENTITY

Coordinator	Karl Aiginger, Director, Austrian Institute of Economic Research
Consortium	<p>Austrian Institute of Economic Research Budapest Institute Nice Sophia Antipolis University Ecologic Institute University of Applied Sciences Jena Free University of Bozen/Bolzano Institute for Financial and Regional Analyses Goethe University Frankfurt ICLEI - Local Governments for Sustainability Institute of Economic Research Slovak Academy of Sciences Kiel Institute for the World Economy Institute for World Economics of the Hungarian Academy of Sciences KU Leuven Mendel University in Brno Austrian Institute for Regional Studies and Spatial Planning Policy Network Ratio University of Surrey Vienna University of Technology Universitat Autònoma de Barcelona Humboldt-Universität zu Berlin University of Economics in Bratislava Hasselt University Alpen-Adria-Universität Klagenfurt University of Dundee Università Politecnica delle Marche University of Birmingham University of Pannonia Utrecht University Vienna University of Economics and Business Centre for European Economic Research Coventry University Ivory Tower</p>
European Commission	Domenico Rossetti di Valdalbero, DG Research and Innovation
Duration	1 April 2012 – 31 March 2016
Funding scheme	FP7 Collaborative Research Project
Budget	EC contribution: EUR 7,999,858.25
Website	www.foreurope.eu
For more information	Kristin Smeral, wwwforeurope-office@wifo.ac.at