ECONOMIC GOVERNANCE

Governing the EU out of the Economic Crisis

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During the next Trio Presidency, economic and economic governance issues are likely to remain high on the European Union's (EU) agenda for at least three reasons. First, the EU will still have to cope with crisis management, in particular in the field of sovereign debt and in the banking sector. Second, in 2011 and 2012, parts of the current economic governance reform may still need to be concluded – and given its apparent weaknesses, further steps may need to be taken. Third, economic recovery cannot be taken for granted in all Member States, so improving growth performance and economic convergence remain political priorities.

The economic context

The EU's economic outlook for 2011 and 2012 is mixed. Since 2010, economic activity has increased, but average Gross Domestic Product (GDP) growth in the EU remains modest (1.7% forecast for 2011, 2% for 2012). In the eurozone, economic divergence may increase further. France and Italy continue to struggle with competitiveness problems, which limit the scope for export growth, while planned fiscal consolidation is likely to weaken domestic demand. The situation is worse in countries in debt crises: Portugal, Ireland and Greece are stuck in a negative spiral of tight budgetary austerity, causing deficits, low growth and low competitiveness.

The Central and Eastern European Countries (CEEC) are likewise divided into two groups: Countries such as Bulgaria or Latvia struggle to recover after unsustainable booms – Hungary, Latvia and Romania even had to request balance-of-payment loans from the EU and the International Monetary Fund (IMF). Others are converging economically and politically with the eurozone's north: Poland and the Czech Republic created a competitive export-base in the pre-crisis period.[1] On the EU's future economic map, the East-West divide may be replaced by a centre-periphery-line that runs right through the eurozone.

1. Of course, despite these positive prospects, the Central and Eastern European Member States remain vulnerable to the growth performance of the EU, as domestic demand is not yet robust

In the EU, one of the most important risks to economic recovery is that the financial sector gets under further stress, possibly causing a credit crunch. Demand could break down, also as a consequence of fiscal austerity, which weighs heavily on domestic consumption in some Member States. An overarching challenge is to regain trust in financial markets.

External developments, such as demand in the main export markets and the euro's echange rate, will also influence the EU's economic performance. A crash of the United States' (US) economy or ongoing uncooperative exchange rate policies of emerging countries would lead to an appreciation of the euro. This would weigh heavily on the eurozone's economic recovery and would increase divergence.

The Trio Presidency in the new Lisbon context

The combination of reforms of the Lisbon Treaty and the EU's persistent crisis-management mode has increased the role of the European Council. Intergovernmental working methods are on the rise, and not only because the European Council has never met so frequently for European and eurozone summits as it did since the start of 2010. Another example is the elaboration of proposals for economic governance reform by the Van Rompuy Task Force. The European Commission was present during the meetings, but had to struggle for its role as an initiator of legislation. It tabled six legislative acts just a few weeks before the Task Force submitted its report to the European Council. The European Parliament, which acted as a co-legislator on four of the six legislative acts, was likewise more or less politically sidelined by the Task-Force. A further indicator for the rise of intergovernmentalism is the demonstrated willingness of some Member States to work in couples (for example, the United Kingdom (UK) and France on defence, France and Germany on economic governance reform) or small groups (the rather spontaneous joining of forces of the UK, France and Germany at the EU summit in October 2010, the letter of the net payers, etc.). Germany's Chancellor, Angela Merkel, has openly defended the intergovernmental "Union Method" against critics who argue that the "Community Method" is being undermined, in particular by larger Member States.[2] The most obvious example was probably the " Competitiveness Pact" (later dubbed the "Pact for the Euro" and then the "Euro-Plus Pact") as proposed by Germany and France in order to establish an agenda for closer social and economic policy coodination among the 17 heads of state and government of the eurozone.

The rotating Presidency's task to chair the Council, committee and working group meetings, and to organise and moderate behind the scenes in legislative procedures will remain important

2. Angela Merkel, "Rede von Bundeskanzlerin Merkel anlässlich der Eröffnung des 61. akademischen Jahres des Europakollegs Brügge", [Speech by Federal Chancellor Angela Merkel at the opening ceremony of the 61st academic year of the College of Europe in Bruges], 2 November 2010, available in German at: http://www.bundesregierung.de/Content/DE/Rede/2010/11/2010-11-02-merkel-bruegge.html – in English and French at: http://www.coleurop.be/events/2186

– and may become more complex compared to pre-Lisbon-times. The reasons for more complexity and possibly more political tensions are the new power relationships resulting from the Lisbon-reforms and more codecisions involving the European Parliament in more and more sensitive policy areas.

If it wants to gain visibility as an agenda setter, the rotating Presidency will have to engage strongly in the EU with Lisbon. This former key function of the rotating Presidency is now strongly limited by the permanent President of the European Council. The Commission may also have to become more assertive if it wants to define political priorities for the EU. On the one hand, this limits the agenda setting scope of the rotating Presidency even further. On the other hand, the rotating Presidency and the Commission may be natural allies if they agree to jointly push issues onto the political agenda.

The Trio Presidency should also join forces early with influential Member States, who gain relative importance through their direct access to the permanent President of the European Council. Strong involvement of the rotating Presidency with the European Parliament should not only be sought in legislative day-to-day-work. The Parliament can provide an important political forum for the Trio Presidency, given its manifest interest to increase its political role in economic governance. It is in any case an influential in four legislative acts of the so-called Rehn Package or in upcoming Single Market legislation. It will likewise seek to extend its role informally when the new mechanisms for economic policy coordination will be put into place.

Prioritity 1: Ongoing crisis management

Given the economic outlook, the foreseeable evolution of the sovereign debt crisis and the fragility of the banking system, crisis management may be required in 2011 and 2012. The Trio Presidency chairs the Economic and Financial Affairs Council (Ecofin) meetings and will hence naturally be involved, but there are two limiting factors for the Trio Presidency's role. First, in the case of a truely severe crisis, the European Council will very probably be, once again, in the driving seat. Second, most issues will have a strong eurozone-dimension and will thus be debated in the Eurogroup, chaired by Eurogroup President Jean-Claude Juncker – where the Polish and the Danish rotating Presidencies are not even present. However, if the crisis seriously hits the banking sector, the CEEC will likewise be affected and cooperation in the EU-27 will be required.

The EU could also face a political crisis, for instance in Ireland or Greece, if either government turns away from their very ambitious reform agendas. This would trigger a negative evaluation by the EU and IMF, which would then probably refuse to pay the next credit tranche to the highly indebted country in question. Portugal is also facing a period of political instability, as may be true for Belgium and Spain. The 2011-2012 period could witness increasing polarisation between peripheral Member States struck by the financial crisis and Germany, which is likely to be, once again, blamed for the economic problems, the financial market reactions

and for an imposition of its preferred set of governance reforms. In these countries that are subject to EU / IMF conditionality, public opinion may also turn on the EU for imposing too much austerity, which harms growth, and too far-reaching structural reforms.

Even after 2013, when the new European Stability Mechanism (ESM) will be in place, an "orderly default" is not to be expected, as the ESM and its rules for creditor involvement will most probably be based on so-called collective action clauses, which will only apply to newly emitted debt. Hence, the negative consequences of a legally and institutionally unframed default would have to be borne. The task of the EU and its Member States would not only be the political stabilisation of the Member State and those groups that would support a return to a reform and consolidation track. Most importantly, the financial sector would require stabilisation, as the effects would be widely felt beyond the borders of the Member State and could provoke domino effects.

Priority 2: Strengthening the new framework for economic governance

Four years into the crisis, the EU is about to accomplish a broad economic governance reform driven particularly by the sovereign debt crisis. When the 2011-2012 Trio Presidency takes over, the reform of the Stability and Growth Pact will be either completed or about to be decided. The basic elements of the ESM have been agreed at the European summit on 24-25 March 2011, while details will probably still need to be settled throughout 2011. The so-called « Euro-Plus Pact » will celebrate its first anniversary in March 2012, right in the middle of the upcoming Trio Presidency. First conclusions will be possible whether this is an accepted and efficient tool for policy coordination and how it relates to the new macro-surveillance procedure that is to be launched in 2011.

At least three weaknesses remain that are likely to require further reforms. First, as there is no transfer of competencies to the EU-level and no automatism in implementing the surveillance mechanism, there is a danger that national policies will not be disciplined sufficiently. Even if market discipline backs the rules-based approach, coordination may not succeed to introduce a European logic into national policy-making. If national policy makers perceive that their scope of action is reduced, this can have two consequences: Either, European interference will be more or less ignored; Or « Brussels » will be blamed for illegitimate interference. A debate on limits to sovereignty and the technocratisation of politics is likely to emerge.

Second, it is by far not guaranteed that the reforms put the eurozone on a convergence track. Some of the highly endebted countries are likely to have difficulties improving growth and competitiveness through structural reforms and consolidation. Furthermore, it is unlikely that the Europe 2020 Strategy will decisively contribute to their catch-up-process. If the periphery decouples even further, the EU will have to decide whether to support the catch-up process by higher transfers – or to surrender its own convergence and cohesion objectives. The countries concerned would have to cope with high unemployment and ongoing pressure on public finances, which restricts investment in education, research and innovation, with no possibility to devalue the currency or to inflate. Political and social costs would be high and populism could rise. There is hence a need to pursue reflection: which instruments and mechanisms can legitimately help increase convergence in the eurozone?

The new permanent crisis resolution mechanism has taken further shape at the March 2011 summit. But the tedious negotiations reveal that several fundamental problems remain to be solved. First of all, there is not yet a general consensus what purpose the ESM should actually fulfill. While the German position is to have the ESM only to prevent the worst (i.e. a crisis that could endanger the euro), there are good arguments for a more pro-active use of liquidity aid to help prevent self-fulfilling financial crises. Also, the EU is probably not politically ready to accept that providing credit may actually entail the risk of losing it. In other words, the idea that there could be a need for transfers from some Member States to others is not accepted. This case should be consciously prepared in order to prevent a severe decline in public support for the euro in the donor countries. Finally, the ESM, as it looks today, will most probably not be able to provide for an "orderly default" for those Member States who are in a liquidity crisis and need debt restructuring. To make this an option, Member States would have to move beyond the current framework and set up a formal legal procedure that would also allow agreements with other governments who are lenders.

Indeed, even if the ESM is agreed in detail in the course of 2011, the EU will be far from having solved its sovereign debt crisis. One political taboo remains: how to deal with banking sector problems. European banks would be seriously affected if the sovereign debt crisis develops further and if debt restructuring has to be undertaken – and this fact considerably limits the political options on how to deal with insolvent Member States. The Ecofin should in a first step revisit the question of stress tests. The EU has already conducted two rounds of tests that essentially helped to hide the real problems. Effective tests would provide for transparency – and hence the fundament upon which the necessary recapitalization and restructuring of banks could then be undertaken in some Member States.

If a reform process is triggered, this may be once again driven by larger eurozone Member States together with the President of the European Council and the Commission. The Trio Presidency risks being marginalised as none of the Trio-members is a medium-sized or larged eurozone country. Nevertheless, with mostly an outsider's view, the Trio Presidency may be able to point to the sensitive points that the Council has not yet solved.

Priority 3: Enhancing growth perspectives

In order to strengthen the economic recovery process, what the EU needs is a vitalisation of old and new sources of growth. Part of this strategy would be to raise productivity based on increasing skills of a larger workforce, higher investment in productive capital based on free enterprise, and supporting innovation in a liberalising world trade environment. But new

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sources of growth would likewise need to be mobilized by developing the internet, communication technologies, environmental protection and alternative energy technologies. The annual work programme of the Commission includes several initiatives in these areas which can be built upon.

Furthermore, European integration itself should be made an additional source of growth and employment. Key elements of such a strategy could include, first, a further development of the Single Market. The "Monti report" sets out a broad strategy, which now requires implementation.[3] Legislative initiatives by the Commission form the core of this work and involve the Trio Presidency. Benefits from market integration should also be sought on the international level, which is a key argument for the Trio Presidency to push towards a conclusion of the Doha round and to promote a new trade policy.

Second, the Europe 2020 Strategy should be reviewed by the end of 2012. Given the evolving divergence in the EU, an interesting question is how a failure of some countries to fulfill the targets will impact cohesion and convergence perspectives. This raises the question of how to provide the necessary infrastructure for growth in these Member States. One of the key priorities of the growth strategy, research and development (R&D) spending, should be critically scrutinised. In some Member States, public finances are tight, infrastructure is lacking and private-sector R&D investment track records are weak. Under these conditions, Member States with weak competitiveness may fail to fulfill the targets. If the highly competitive Member States comply with the targets, this will contribute to widening the competitiveness gap.

Third, an intense political debate on the 2014-2020 financial framework will develop, in particular once the Commission has submitted its Communication. While most Member States will prefer to take positions on the size of the budget and net contributions, a value-added of the Trio Presidencies could be to focus the debate on political priorities.

Conclusions

The next Trio Presidency has some scope to co-shape some of the priorities on the EU's and the eurozone's broad economic and economic governance agenda. Yet, in this complex political setting, it will only be one of many voices.

In public opinion, under the effect of the economic crisis, two tendencies combine: On the one hand, there is less support for integration (as in almost every economic crisis situation in a Member State since the 1950s) and falling trust in the EU and national institutions. On the other hand, citizens formulate clear expectations towards the EU, increasingly including

3. Mario Monti, "A new strategy for the Single Market – At the Service of Europe's Economy and Society", Report to the President of the European Commission, 9 May 2010, available at: http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

economic wellbeing and social security. It is therefore key to explain why the currency union may need further steps of integration and how prospects for growth and employment can be improved. The instruments, such as further market integration or more political integration, will require justification and explanation. The relative economic and demographic decline of the EU is probably one of the strongest arguments underlining the need for EU Member States to move closer together. In 2011 and 2012, political energy may be, once again, mostly directed towards crisis management and the implementation of economic governance reforms, which are currently being completed. But as these are insufficient, the next reform objectives need to be defined. The next Trio Presidency – mostly from the outside of the eurozone – should attempt to drive this debate.