The economic governance that the EU needs

Yes, the eurozone crisis could have been handled better, says Guy Verhofstadt, but the real crisis facing Europe is about economic policy governance. He puts the case for bringing all its elements under a single framework, with the European Commission at the centre

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Two lessons have emerged from the financial crisis: First, there is no substitute for timely and co-ordinated action when the single currency is under pressure; second, all eurozone countries are effectively in the same boat, and if the boat springs a leak everyone sinks.

A quicker and more concerted response might have limited the fall-out from the crisis, and so cost less. The European Financial Stabilisation Facility (EFSF) set up in a hurry in May of last year in an attempt to stop the rot will shortly be able to call on some €500bn in the event of any further eurozone countries facing serious liquidity problems. From 2013 onwards, eurozone member states have also agreed to perpetuate this financial stability mechanism, and even to amend the Lisbon treaty to avoid any legal ambiguity.

Despite all this, the markets are still not convinced by eurozone shows of solidarity. Greek sovereign debt has been further downgraded to below that of Egypt, Portugal is having to call on assistance from the EFSF and the IMF and Irish banks reportedly need an additional €24bn to stay afloat. Spain, meanwhile, is doing all it can to avoid the contagion spreading.

The irony is that the euro has been a hugely successful project and brought a considerable degree of stability to participating countries in turbulent times that they would not otherwise have enjoyed. Without it, many of them would have succumbed to a downward spiral of devaluations, defaults and recourse to the IMF. The European Central Bank has been crucial in preventing a worst case scenario, but the obvious lacuna in Europe's economic and monetary union (EMU) project was that it only established a monetary union and largely omitted the economic union that has proven so intrinsically linked to the strengths and weaknesses of the single currency.

The real crisis facing Europe is one of economic policy governance. There has been an increasing tendency for eurozone member states to go their own way, even to overtly defend a more nationalist economic policy to the detriment of the eurozone as a whole. That is not to say that we need a one-size-fits-all economic policy imposed on everyone, but rather a higher degree of co-ordination and convergence of the broad thrust of economic policymaking that at the very least would ensure that everyone is heading in the same direction. Rather like cars on a motorway – some may drive slower than others but there are minimum and maximum speeds and they all have to be heading in the same direction. A rogue driver going against the main traffic flow will cause a major pile-up if not stopped.

The second governance issue relates to economic policy co-ordination. Just as all drivers must respect rules for safety, anyone who breaches them has to be held to account and, possibly penalised because anarchy would have such devastating effects. So it is with economic governance.

There needs to be agreement on both the rules and on the impartial body responsible for enforcing them. EU leaders have in recent summits come close to identifying a number of common economic policy areas where closer co-ordination is desirable if competitiveness is to be improved. These include sustainability of pensions, wage-to-productivity ratios, corporate tax policy, investment in R&D and the financing of major infrastructure projects. Yet the same EU member states have consistently failed to endow the European Commission with the overall responsibility for holding member governments to their commitments and, where necessary, imposing penalties for breaches. This intergovernmental approach lay behind the failure of the Lisbon Agenda to deliver the results needed to make Europe more competitive and dynamic by 2010, and

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By Sebastian Dullien

But the real question is how eurozone sanctions are applied – and by whom

Guy Verhofstadt is absolutely right when he says that closer co-ordination of economic policies across the euro area is needed to keep the currency union viable. He is also correct that a soft co-ordination process won't lead to meaningful policy co-ordination. So his proposals give us welcome food for thought.

But unfortunately his suggestions also have their short-comings. He seems ready to accept the member states' most recent agreement to focus co-ordination on improving competitiveness, even though the list he presents in his proposal – the same as that of Germany's Chancellor Angela Merkel – is far from coherent. It includes, among other things, sundry items ranging from the sustainability of pensions to corporate taxation and even R&D spending. While one might agree that these things are desirable, it is unclear how they can help to solve the immediate problems confronting Europe.

The eurozone's central challenge is to resolve the massive build-up over the past decade of macroeconomic imbalances, and to prevent a recurrence in years to come. Quite apart from the unsustainable real estate booms that built up in Spain and Ireland, it is diverging price competitiveness that is at the heart of these imbalances. Unit labour costs and domestic demand have increased much more strongly in countries at the periphery of the eurozone than in Germany.

will bedevil the new Europe 2020 successor strategy too.

The same failure of governance has characterised the Stability and Growth Pact, designed (largely by Germany) to ensure compliance with basic precepts of stable and sustainable monetary policy by limiting the size of national debt and annual deficits in relation to GDP. Most eurozone members are now in breach of the Maastricht criteria, yet none have been subjected to the fining envisaged by the SGP's authors. Recently adopted changes to it provide for a more sensible and graduated system for sanctioning recalcitrant countries, but still leave the decision to initiate an excessive deficit procedure to the member states themselves, rather than providing for the more automatic mechanism that was originally envisaged by the European Commission.

The internal market that is one of Europe's major policy successes is policed by the

MATTERS OF OPINION

Broad support for the EU's crisis leadership

The worst effects of the economic crisis on jobs have yet to be felt, according to a Eurobarometer survey at the end of last year. It found that 48% of EU citizens across all 27 member states feared worse was to come on the jobs front, compared to 42% who thought that peak unemployment had passed.

The optimists could be gaining ground, though, as their numbers rose five percentage points from a similar survey just over a year ago in spring 2010, while the pessimists fell seven points. Not surprisingly, opinions varied significantly across the EU, with people in Portugal, Ireland and Greece most likely to say the full impact of the crisis on jobs was yet to come and with optimism rising steeply in Germany between the two surveys.

Asked which authority they thought was best-placed to take action against the financial and economic crisis, most said the EU (23%). Opinion was split between eurozone countries and other EU countries. Outside the eurozone, more people would prefer their national government rather than the EU to tackle the crisis. But eight out of ten said they'd like the EU to play a more important role in financial market regulation. On reform and regulation of the global financial system, most (25%) thought the IMF should take charge of this with the EU not far behind (21%), followed by the G20 (18%).

There was broad support for the EU's strategy for emerging from the crisis: the seven flagship initiatives and the 'Europe 2020' policy priorities. Most people surveyed (46%) thought the EU was headed in the right direction, with less than one in four (23%) saying it was wrong. □

THE EU IS WELL PLACED TO REGULATE AND REFORM GLOBAL FINANCIAL MARKETS, JUST BEHIND THE IMF

In your opinion which of the following is best placed to regulate global financial markets?

Eurobarometer 74

Commission, which annually draws up league tables charting EU governments compliance with its rules. It also launches infringement proceedings against member states that have not implemented agreed directives on time, or in the correct manner. Similarly, EU competition policy has over many years brought a coherent approach to the market place by standing firm against monopolies and abuses of dominant positions, and here again the Commission plays the role of a neutral judge. There may in some cases be disputes, but the system has brought a degree of legal certainty across the single market that the EU's member states could not have achieved on their own.

The challenge now for EU leaders is not whether we can repackage old policies but whether we have the collective vision and will to act together. I have been arguing for a Community Act rather than a Competitiveness Pact that would bring together all the elements of economic governance under a single framework with the European Commission at its centre. As was the case with the single market programme of the 1980s, the Commission could be in charge of overseeing a convergence of national economic policies around the EU within certain parameters. Straying outside those parameters would lead to warnings and sanctions, but otherwise there would be some flexibility for member states to pursue the goals at a pace adapted to their national circumstances. A cluster of EU commissioners holding economic-related portfolios could even be made responsible for steering the process forward, providing it with direction and momentum.

Getting Europe back onto a glide-path for growth is the biggest challenge we face

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Most of the elements mentioned by Guy Verhofstadt don't even touch upon these problems. How, for example, could the sustainability of pension systems resolve divergences of price competitiveness? If pensions in a country are too generous to be financed at the current retirement age, either pensions have to be cut or people have to work longer. There is no direct link to current or future divergences of price competitiveness, nor is there a need for co-ordination. The same holds true of corporate taxation. If eurozone co-ordination on this means an increase in low-tax countries such as Ireland, how should that help the Irish to regain their lost competitiveness?

If we want to prevent a replay of the crisis in the eurozone's periphery, then we need to be clear about who actually contributed, and how much, to the macroeconomic imbalances. Thus, deficit countries like Portugal, Ireland and Spain should be chastised for excessive wage growth and for policies that failed to prevent the house price bubble, and then encouraged to increase the competitiveness of their economies. But surplus countries like Germany also need to be reprimanded for spending far too little on public investment and for overseeing an unrelenting policy of wage depression.

Before talking about enforcing policy co-ordination, we need to first make sure that everyone is on the same page when it comes to analysing the underlying problems. Effective macroeconomic policy co-ordination needs to be more than a potpourri of supply side reforms; it actually needs to allow the European level to conduct or influence national fiscal and wage policies.

today. Our economies are being overtaken by other, more innovative ones around the world – such as China, India and Brazil – and our governance model isn't keeping pace with events in the global village. A major issue is how to finance large infrastructural projects at a time when money is so tight. The costs of upgrading our trans-european energy and transport links far outstrip the economic capabilities of individual member states, especially those on the EU's periphery that are most in need of better connections yet are among the most vulnerable to sovereign debt problems. The EU can, however, benefit from economies of scale, so joint ventures and public-private partnerships can plug the gaps in the networks. But that sort of investment requires much more collective thinking about our needs and our budgetary resources, and will demand the more extensive use of eurobonds.

For European nations to emerge stronger from the current crisis, and able to face up to the significant policy challenges of the 21st century, they need to think bigger and put more and not less faith in the collective enterprise that is the European Union. It should be remembered that European unification was conceived as a project of pooled sovereignty, not surrendered sovereignty. Europe's governments must not run scared of nationalist or eurosceptic parties back home that decry closer supranational co-operation; their duty is not just to survive the present but to lay the ground for the future. □

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Ambiguities over which goals should be achieved through co-ordination also cast doubt on the proposal to give the European Commission the power to issue warnings and impose sanctions. If we were talking only about the mechanistic enforcement of a simple and undisputed rule, this would be acceptable. Unfortunately, European leaders yet have to agree on the rule in question. The current proposals to monitor macroeconomic imbalances through a multi-dimensional scoreboard are far from being easily enforceable without the exercise of political judgement.

The Commission has so far been evasive about clarifying whether it would sanction current account imbalances symmetrically (meaning that not only Portugal, but Germany too would be fined), and has implied that the final decision would therefore be a political one. Given the way the Commission's own members are selected and its own governance procedures, the Brussels executive clearly lacks the democratic legitimacy needed to take such far-reaching decisions.

There are two possible paths for remedying this problem: Either the co-ordination process should be simplified around the single straightforward rule of limiting current account deficits and surpluses to a certain share of GDP, or alternatively, any decision on sanctions is transferred to a democratically legitimate body like the European Parliament. Unless one or the other is chosen, effective macroeconomic policy co-ordination will remain a mirage. □

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