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THE MESSY REBUILDING OF EUROPE

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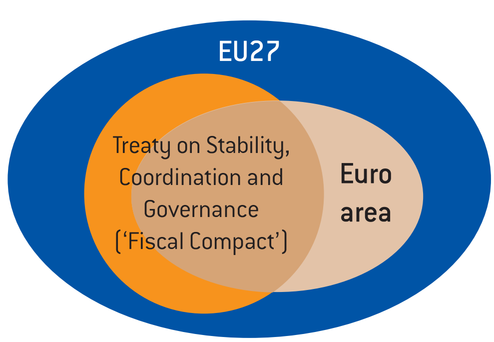
THE ISSUE The euro crisis and subsequent policy responses have challenged the assumptions underpinning the governance of the euro area, and the relationship between the European Union's euro- and non-euro countries. The euro policy regime has become increasingly complex and difficult to manage, raising the question of the accountability of decision making to citizens. Complexity also threatens to create frustration for euro-area members, which fear that initiatives to strengthen the euro will be hindered, and for non-euro members, which fear that they will be *de-facto* deprived of their say in decisions of major relevance to them.

POLICY CHALLENGE

It is too early to determine if and how policy integration within the euro area will develop beyond its current limited monetary and budgetary remit. Alternative scenarios can be envisaged, from the building of a coherent euro area within the EU, to a fragmentation of the financial market and a generalised 'variable geometry'. Policy action should be based on the need to (a) make room for deeper integration within the euro area, beyond the limited remit envisaged in the Lisbon treaty; (b) preserve the integrity of the EU27 and its essential governance arrangements; (c) ensure equal treatment in the application of common rules; (d) ensure that candidates for euro-area membership have a voice in the definition of its rules; and (e) balance the requirements of legal clarity, accountability and efficiency with the desirability of experimentation through variable geometry.

Overlapping and complex governance



Source: Bruegel.

THE EURO CRISIS and the way policymakers have responded have challenged the assumptions underpinning the euro-area's governance, and the relationship between the European Union's euro- and non-euro countries. As more steps are taken in response to the weaknesses in the euro policy regime revealed by the crisis, the EU will face new challenges of the same sort. This Policy Brief provides input to the policy discussion on the governance of the EU/euro area relationship[1].

The governance model of what could be called EMU 1.0 was based on three assumptions: first, that Economic and Monetary Union only required, in addition to EU single market provisions, delegation of monetary policy to the common central bank and the avoidance of excessive budget deficits; second, that governance could be grounded on rules-based prevention only, and that there was no need for crisis management; third, that all EU countries would eventually join EMU (at least those without a waiver).

These assumptions made the governance of the EU/euro area relationship relatively simple. Euro-area relevant provisions could be designed as a self-contained set of rules applicable to euro members, and those rules interfered minimally with the general rules applicable to all EU members. Single market integration was seen as contributing to the strengthening of the euro, while being beneficial to all. Governance could rely on the machinery of the Economic and Financial Affairs Council (ECOFIN) for the implementation of formal rules, while the Eurogroup, consisting of the finance ministers of euro-area countries – a late addition to the governance framework – limited itself to the monitoring of economic developments and the preparation of ECOFIN decisions relating to the Excessive Deficit Procedure.

This barebones EMU failed the test posed by the crisis. It is now recognised that a sustainable currency union requires more governance because of the higher degree of economic, financial and fiscal spillovers than those existing outside the currency union:

- Beyond strengthening of budgetary discipline, decisions since 2009 include the creation of a crisis management and resolution mechanism; prevention initiatives in fields such as competitiveness and its determinants, macroeconomic imbalances, and financial stability; and the gradual build-up of a hands-on euro governance structure that functions in a markedly more discretionary way than before the crisis. Further discussions suggest that the strengthening of the euro area could eventually have other consequences such as access to specific budgetary resources, banking regulation and supervision, public-debt management and political union. These developments are blurring the previously clear distinction between euro-area and EU management.
- The crisis has led to a recognition that for individual countries, participation in the single currency is more demanding than initially perceived. Although all but two of the EU27 are formally committed to joining the euro, there is agreement that the economic preconditions for successful participation must be met before the irrevocable locking of exchange rates. This opens up the possibility that the coexistence between euro-area members and a relatively large group of non-euro EU members will last for longer than initially assumed.
- The Eurogroup has increasingly assumed the role of a *de-facto* executive body.

Two other factors make the discussion about the relationship between EU and euro-area governance difficult. First, these groupings are not stable, and this results in differences in attitudes: non-euro countries that do not intend to join in the near future are primarily interested in limiting spillover effects from euro-area decisions onto the wider EU, while countries that want to join the euro are concerned to avoid a situation in which it becomes increasingly difficult to join a more deeply integrated euro area. Second, the two categories of country are not homogeneous legally, economically and politically. Even among the current 17 euro-area members, there are significant differences that imply different appetites for integration. These two factors make it difficult to rely on the basic rule that all rules for EU/euro-area relationship should simply be defined by all EU countries together.

Until now, the EU has dealt pragmatically with this complexity.

1. This Policy Brief is an edited version of a paper prepared for the informal ECOFIN of 30 March 2012 at the invitation of the Danish Presidency of the EU Council.

The basic governance model has been retained while new components have been added either at euro-area level (for example the European Stability Mechanism), at EU level (for example the European Semester), or in *ad-hoc* formats (as for the Euro Plus Pact or the Treaty on Stability, Coordination and Governance (TSCG)).

As a consequence, the decision-making system has been made more complex and difficult to manage, bringing into question its perception by, and accountability to, citizens. Complexity could also create frustration among both euro- and non-euro members. Euro-area members fear that initiatives deemed essential for strengthening the euro will be hindered by excessive governance complexity resulting from the demands of non-euro members, who fear in turn that they will be *de facto* deprived from having their say in decisions of major relevance to them.

RECENT DEVELOPMENTS IN GOVERNANCE AND CONSEQUENCES FOR THE EURO AREA/NON-EURO AREA RELATIONSHIP

Pre-crisis governance distinguished between euro-area countries and non-euro area countries. ECOFIN plays a central role in EU economic decision making. A number of decisions related to the euro area can, however, be taken by the ECOFIN with only euro-area countries voting. Indeed, the Lisbon Treaty established a stronger role for euro-area countries in preparing and finalising recommendations and decisions on budgetary discipline and broad economic policy guidelines[2]. The Stability and Growth Pact (SGP) in principle applies to all 27 EU member states. However, sanctions are foreseen only for the euro-area member states. Moreover, only euro-area countries can vote on Excessive Deficit Procedure steps that involve only euro-area countries. The Eurogroup was given a treaty-based role by the Lisbon Treaty[3]. However, formal decisions can only be taken by ECOFIN, and the Eurogroup is therefore the forum for deeper discussions among euro-area finance ministers, for example on matters related to the implementation of the SGP.

The first governance reforms to address the weaknesses laid bare by the crisis stayed within the Treaty's remits and implicitly deepened the legal and institutional gap between euro-area and non-euro area countries. Most of the so-called Six-Pack reforms[4] are based on the Lisbon Treaty and therefore perpetuate the clear distinction between euro-area and non-euro area countries. In particular, regulation 1175/2011 on the strengthening of the surveillance of budgetary positions applies to the EU27, but the associated sanctions refer to the euro area. Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances also applies to the whole EU. However, the alert mechanism, which is part of the regulation, is, in accordance with Article 121(3) of the TFEU, discussed in the Eurogroup for the euro-area countries. Also, the so-called Scoreboard, which forms the basis of the alert mechanism, distinguishes between euro-area and non-euro area countries. Finally, the enforcement mechanism to correct excessive macroeconomic imbalances adopted as part of the Six Pack is exclusively addressed to euro-area countries (Regulation 1174/2011). For the most part, the regulations require qualified majority voting (QMV) by the Council to adopt a European Commission recommendation. For euro-area countries, only euro-area countries vote. Overall, the Six Pack strengthened euro-area governance, and by doing so, the legislation increased the gap between euro-area and non-euro area countries. Indeed, stronger and more binding rules for euro-area countries imply a wider legal gap and may also result in diverging economic policy stances.

The Treaty on Stability, Coordination and Governance (TSCG) marks a significant change to the governance of the EU, and exposes the growing tension between national sovereignty and supra-national logic. The new treaty has two main elements. Articles 3-8 cover the so-called Fiscal Compact, which requires the main elements of the SGP to be transposed into national legislation at a constitutional or equivalent level. The correctness of the transposition into national law can be challenged in the EU Court of Justice (ECJ). At the same time, national parliamentary prerogatives are safeguarded. This implies that ultimately, the ECJ may have to judge if a transposition into national law of the TSCG provisions concerning the fiscal Correction Mechanism – while not in line with the requirements – may nevertheless be lawful, because the national

2. Article 136 of the consolidated Treaty on the Functioning of the European Union (TFEU).

3. Article 137 of the TFEU.

4. A set of five regulations and one directive dealing with economic and fiscal surveillance that entered into force at the end of 2011. See http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

parliamentary prerogative prevails (Article 3(2) of the TSCG). Articles 9-14 deepen governance *inter alia* by establishing regular Euro Summits. Overall, the new treaty renders the tension between national sovereignty and the logic of supra-national intervention clearly visible.

The TSCG also creates a new 'variable geometry' according to which countries cannot be easily classified into euro area and non-euro area. Already the directive on requirements for budgetary frameworks of the member states, which is part of the Six Pack, marks a departure from the euro-area/non-euro area framework. The directive is addressed to all EU members, although the United Kingdom has an exemption from a number of the directive's main provisions. The TSCG will enter into force when 12 euro-area countries have ratified it. Its content will then apply to all countries that have ratified it including non-euro area countries to the extent that they chose to opt-in. The new Euro Summit illustrates the potential for 'variable geometry'. The Euro Summit president is elected by the heads of state and government of those euro-area countries that have ratified the TSCG. Each year, the heads of state and government of all countries that have ratified the treaty will meet in a Euro Summit. It is thus conceivable that there will be a Euro Summit involving several non-euro countries but excluding one or several euro-area countries (TSCG, Article 12).

On the financial supervisory front, the new institutions that have been created are in principle institutions for the whole EU, but some differentiation between euro-area and non-euro countries is becoming visible. For example, the European Systemic Risk Board (ESRB) gives a leadership role to the European Central Bank, which finances the ESRB secretariat. There is also an emerging debate on the use of macroprudential instruments to differentiate between euro-area countries in order to mitigate the unintended consequences of a single monetary policy. The ESRB may eventually make macroprudential policy recommendations to euro-area countries that would not apply to non-euro area countries with an independent monetary policy. Similarly, the European Banking Authority (EBA) is an EU27 institution. However, in the context of the currently debated Two Pack legislation[5], the EBA will play a special role for the euro-area countries by requiring euro-area members in financial difficulties to report additional information to the EBA[6].

In terms of financial assistance, the model has become more centred on the euro-area countries. At the start of the euro sovereign debt crisis, there was uncertainty about the responsibility for macrofinancial assistance for euro-area countries, since no such assistance was foreseen in the EU Treaty. For Greece, there was a temporary coexistence of different instruments (bilateral loans, European Financial Stability Facility). For other countries receiving financial assistance, variable geometries were established, with some non-euro area countries participating in the assistance given to Ireland. The current model appears to focus on the European Stability Mechanism (ESM), which will be an instrument for euro-area countries only. However, the ESM Treaty only grants access to financial assistance to those euro-area countries that have ratified the TSCG. Financial assistance to non-euro area countries will continue to come from the EU-based balance-of-payments assistance, as foreseen by the EU Treaty. The IMF involvement in financial assistance further complicates the situation because it implicitly gives a voice to all EU (and also non-EU) countries in assistance packages for all euro-area and non-euro area countries.

The crisis has affected the relative roles of Council formations and increased the role of intergovernmental decisions. In 2010-11, decisions were often taken by the EU's heads of state and government, even though they were often technically within the remit of finance ministers. Many decisions were also taken on the basis of *ad-hoc* intergovernmental deliberations. However, there is a view that the Eurogroup has gained in importance relative to the ECOFIN[7]. In addition to standard fiscal surveillance decisions, the Eurogroup has in particular been the key body taking decisions to address programme reviews, the Greek private sector involvement and the fragility of the banking system. While non-euro area countries seem to recognise that it is legitimate that euro-area countries discuss such matters in the Eurogroup, some deplore the absence of a real ECOFIN discussion on these matters, even though events in

5. See Table 1 (page 8).

6. See Article 3 of the proposal, part of the Two Pack, for a regulation on the strengthening of economic and budgetary surveillance of member states experiencing or threatened with serious difficulties with respect to their financial stability in the euro area. See Table 1 on page 8.

7. The senior officials interviewed as background for this paper generally agreed on this point.

Greece or other euro-area countries have clear implications for non-euro area countries. Some non-euro area countries also felt that the application of common rules could become uneven because the same rules were de facto applied differently by the Eurogroup and the ECOFIN[8].

With increasing variable geometry, the decision-making process has also become more complex. Voting rules are becoming more complex involving different groups of countries in different cases. Different member states participate in the financial assistance programmes. In the context of the European Semester, the Commission, the Council and the European Parliament provide ex-ante guidance to national decisions relating to fiscal policy and national reform programmes. At the same time, more and more crucial decisions have been shifted from finance ministers to heads of state and government, who typically take decisions on the basis of consensus. Many observers have equated this development with a strengthening of the inter-governmental nature of decision making. The ESM further adds to institutional and practical complexity by creating an intergovernmental institution that operates outside the regular treaty, and by defining a completely new decision-making structure. At the same time, the TSCG – while being inter-governmental – has strengthened the European Commission's role by introducing reversed qualified majority voting on EDP steps.

Overall, the current legal, institutional and political reality of the EU can be characterised by (1) an increasing legal, institutional and policy divide between euro-area and non-euro-area member states, (2) increasing variable geometry blurring the euro-area/non-euro area distinction, (3) high complexity and lack of clarity, and (4) increasing tensions between the demands of national sovereignty and euro-area sovereignty.

In conclusion, the current set-up is the source of two separate tensions. First, some euro-area countries fear that they will permanently have to make financial transfers while recipient countries find the conditions associated with such transfers overly demanding. Second, for the euro-area and non-euro area countries, the complexity of the current set-up implies a significant drag on economic efficiency.

RECONSIDERING THE ALLOCATION OF COMPETENCES

There is general agreement that the current state of affairs is unsatisfactory. Broadly speaking, the dissatisfaction is seen, depending on the observer, as stemming from one or both of the following two issues:

- An unsatisfactory decision-making process, taking the current allocation of competences between the euro-area and non-euro area countries as a given.
- An unsatisfactory allocation of competences between euro-area and non-euro area countries.

We postpone to the next section the discussion on how to improve the decision-making process. Here we concentrate on three scenarios for redefining the allocation of competences between euro-area and non-euro area countries, and examine their implications for the decision-making process:

1. **A two-speed EU, with a coherent euro area.**
2. **A fragmented EU, with fragmentation even within the euro area.**
3. **A generalised variable geometry EU, with variable geometry even within the euro area.**

Scenario 1 would imply that the euro area evolves from a monetary union with some fiscal rules to a full-fledged monetary union, with a fiscal and banking union. It would have a strong, democratically-legitimate political centre able to impose on national budgetary decisions, a federal budget with direct access to tax resources providing some degree of stabilisation to the national entities and a public debt management capability. It would also have a banking supervisor, a banking deposit insurance mechanism and a banking resolution authority. A monetary union with such fiscal and banking union would achieve the kind of economic coherence and efficiency that the euro area has lacked so far, and thus would seem highly desirable[9]. It would also imply that the euro area becomes *de facto* a political union, with major economic policy areas transferred from the national to the euro-area level, thereby reducing the tensions that result from the current intergovernmental

8. These statements are based on conclusions drawn from our interviews with senior officials.

9. Such a fiscal union is described in Marzinotto, Sapir and Wolff (2011), 'What kind of fiscal union?', *Policy Brief* 2011/06, Bruegel.

approach. While the Treaty allows for stronger euro-area governance based on Article 136, scenario 1 may require a stronger legal base, and could have implications for national constitutions.

To the extent that it would deliver a more stable and better functioning monetary union, this development would benefit the whole EU. It would however result in a two-speed EU, with the EU27 becoming essentially the EU11, ie the coherent euro area plus a bloc of 10 non-euro area members. This would raise the big economic question of the coexistence between the EU single market and the economic policies managed by the euro area. Would it be possible, within the EU, to preserve the integrity of the single market while permitting euro-area countries to manage their economic, fiscal and financial affairs in a manner that is coherent with their monetary union?

A particularly important issue in this respect is banking regulation and supervision: a coherent euro area would presumably develop into a banking union with integrated supervision, yet banking regulation would remain an EU27 competence. This could create a tension between the requirements of financial stability and those of financial market integration, as perceived at EU level.

A euro area acting in a unified manner would presumably have a qualified majority within the Council. Thus the two-speed EU might resemble the European Economic Area (EEA), with the euro area playing the role of the EU and the non-euro area that of the non-EU EEA countries. In other words the euro area might simply decide on single market issues, to which QMV applies, and the non-euro area would have to abide by the euro area's decisions. History has shown however that the EEA model is not really attractive and only a few non-EU countries have been willing to join it. Similarly most (but not necessarily all) non-euro area countries would probably not want to remain inside the EU if it meant that the euro-area countries dictate single market policy.

To find a balance between potentially conflicting interests, it would be necessary to establish rules for the relationship between the euro area and the non-euro area countries. In exchange for moving more competences to euro-area level, procedures for governance should be established to guarantee that no decisions are taken that adversely affect the fundamental economic interests of the non-euro area countries. Alternatively, non-euro area countries could be allowed to adopt different regulations to the euro area for certain matters, which would introduce some form of regulatory competition between the euro area and non-euro area groupings.

Scenario 2 would be the opposite of scenario 1, with the majority of (rather than perhaps just a few) euro-area members deciding that they are unwilling to cede further fiscal and financial sovereignty. A situation in which euro-area countries would only accept limited common disciplines in the budgetary field, would resist significant moves towards economic integration and would judge that banking supervision and resolution need to remain a purely national prerogative, would, in times of crisis, as we have witnessed to a degree recently, and perhaps even in normal times, likely lead to the fragmentation of financial markets and perhaps even product markets. This situation of 'one money, but several financial markets' would effectively mean several co-existing monetary policies within the euro area (probably in the disguise of macroprudential measures), and therefore the degeneration of the monetary union and the EU itself.

Scenario 3 would see not only the continuation but even the further development of the variable-geometry architecture witnessed in recent months. In addition to having most euro-area and some non-euro area countries sign and (in principle) ratify the TSCG treaty, one could see in the future some euro-area and some non-euro area countries sign other intergovernmental treaties, primarily aimed at reinforcing the fiscal and financial dimensions of EMU. We would then have a series of intergovernmental treaties signed and ratified by different groupings of countries, some within and others outside the euro area.

Compared to scenario 1, this would have the advantage of being less confrontational since the dividing lines between groupings would be blurred. However, scenario 3 would not achieve the kind of decision making coherence and efficiency necessary to ensure the smooth functioning of the monetary union.

Scenario 3 is not unrealistic. But it must be asked if this generalised variable geometry can be stable, or if it only represents a transition towards scenarios 1 or 2. This would partly depend on the *modus operandi* for the relationship between euro-area and non-euro area countries, and if it would permit this scenario to serve as a way to explore and experiment with ways of developing a more coherent euro area, while preserving the integrity of the single market. A *modus operandi* involving the strengthening of common institutions such as the European Commission and the European Parliament would be helpful for an evolution towards scenario 1. Clearly basing variable geometry on EU treaty-based enhanced cooperation instead of intergovernmental treaties (or integrating such treaties into the EU Treaty, as envisaged in the TSCG) would be conducive to such evolution. By contrast, a complex web of intergovernmental agreements lacking strong common institutions would increase the likelihood of an evolution towards scenario 2.

IMPROVING THE CURRENT DECISION MAKING PROCESS

A number of measures can be envisaged that would create the conditions for a smooth relationship between euro-area and non-euro area countries within the current set-up. Some measures would deal with the Eurogroup/ECOFIN relationship, for example the exchange of information and the possibility of having informal discussions between euro-area and non-euro area countries on matters that concern primarily the euro area but have major repercussions for other EU countries.

The tougher question is how to improve the decision-making process to meet the requirement for a well-functioning and stable EMU, while minimising the potential detrimental impact on non-euro area EU countries. This issue can be framed as spillover management. A lesson from the crisis is that spillovers from national developments within the euro area are more extensive than initially thought, implying a need for more integration and coordination beyond the traditional remit of EMU. At the same time, spillovers from the euro area onto non-euro area members are significant, meaning that non-euro area interests must be taken into account in decision-making processes.

Our analysis suggests that five objectives should guide decisions on governance arrangements:

1 Make room for deeper integration within the euro area, over and above the limited remit envisaged in the Lisbon Treaty;
2 Preserve the integrity of the EU27 and its essential governance arrangements;
3 Ensure equal treatment in the application of common rules;
4 Ensure that EU members that are candidates for euro-area membership have a voice in the definition of the euro area's core principles and rules;
5 Balance the requirements of legal clarity, accountability and efficiency with the desirability of experimentation through variable geometry.

In the short term, meeting these objectives may require several adjustments to the current institutional set-up:

- The euro area continues to rely on the EU's institutional and legal machinery for implementing decisions. Should it equip itself with specific policy planning capabilities in order to be able to map out options for its own development?
- The European institutions have only partially adapted to the euro-area/EU duality. Given current portfolios, would it be desirable to involve a larger group of Commissioners in the dialogue with the Eurogroup, for example the Commissioners responsible for financial services and for employment?
- National parliaments within the euro area are increasingly concerned about the potential public finance consequences of euro-area initiatives. Should consideration be given to forming a euro-area parliamentary finance committee made up of representatives of the European Parliament's Committee on Economic and Monetary Affairs and finance committees of national parliaments of euro-area countries?
- The combination of a fixed Eurogroup chair and rotating ECOFIN chairs is adding to imbalances between the two formations. Should permanent chairing arrangements be considered for the ECOFIN? In order to ensure consistency, should the ESRB model, with a permanent chair from the euro area (who would also chair the Eurogroup) and a vice-chair from a non-euro area country,

be used for ECOFIN?

- As far as euro membership is concerned, heterogeneity is high among non-euro area countries, in terms of both legal status and policy objectives. Should countries that intend to join the euro within, say, five years be part of policy conversations with a bearing on the euro area's future?
- The Eurogroup is the *de-facto* decision making body for decisions that only apply to euro-area members, and this reality is widely accepted by non-euro area countries as it reflects broader and deeper coordination needs within the euro area. Is such acceptance subject to certain red lines? How could ECOFIN and especially the ministers from euro-area candidate countries be involved in the framing of the future evolution of the euro-area? Should this simply involve an *ex-ante* information exchange on major decisions affecting jurisprudence or should participation in the shaping of these decisions also be considered? For new legislation, should all euro-area candidate countries be included in the negotiations, but without voting rights?
- If the euro area was to develop into a coherent set-up with a single voice along the lines of our scenario 1, should a political agreement be sought on the definition of a supermajority rule within the ECOFIN in order to prevent EU27 decisions that are against the vital interest of non-euro area countries being taken, in particular when there is a risk of conflict with the single market?

This paper draws partly on interviews with senior officials of EU member states and European institutions, to whom we are grateful for having shared their views with us. Opinions expressed in this paper are those of the authors alone. We thank Dana Andreicut for excellent research

Table 1: Increasingly complex decision making

Six-Pack item	Regulation/ Directive No.	Six-Pack Regulation	Applies to:	Voting rule
1	1175/2011	Improving budgetary positions and economic policies	EU27 (with minor exceptions which only apply to euro area+ERM2)	1
2	1177/2011	Improving the excessive deficit procedure	EU27, ECB surveillance only applies to euro area+ERM2 countries	N/A
3	2011/85/EU (Directive)	Budgetary frameworks requirements	EU27, the UK does not have to abide by Articles 5 to 7 (concerning numerical fiscal rules)	N/A
4	1176/2011	Macroeconomic imbalances	EU27	2
5	1173/2011	Enforcing euro area budgetary surveillance	Euro area	2
6	1174/2011	Correcting excessive imbalances	Euro area	3
Two- Pack item	**Regulation No.**	**Two-Pack regulation**		
1	385/2011	Surveillance for member states with financial stability difficulties	Euro area	3
2	0386/2011	Common provisions for draft budgetary plans and excessive deficit correction	Euro area in general (with minor exceptions for members who are subject to macro-economic adjustment programmes or already subject to an excessive deficit procedure)	3
		Agreement		
		Fiscal Compact (TSCG)	EU25 (the UK and the Czech Republic are left out)	4
		European Stability Mechanism (ESM) Treaty	Euro area	5

Voting rules: 1 = QMV, excluding the member state concerned (only euro-area countries vote on euro-area members), Council can reject Commission recommendation by simple majority. 2 = QMV, excluding the member state concerned. 3 = QMV of euro-area countries, excluding the member state concerned. 4 = Reversed QMV (euro-area countries). 5 = QMV or mutual agreement by the Board of Directors and the Board of Governors.

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