

**The Accidental Player:  
The EU and the Global Economy**  
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In a recent paper, Arvind Virmani (2004), the director of ICRIER, looks ahead and envisages for 2050 a tripolar world in which the three powers would be the US, China and India. In a very short paragraph, he dismisses the perspective that the European Union (EU) would become one of the poles in such a world, saying that (a) its population is on a declining trend, and (b) that it would require the unlikely formation of a “virtual state” in which nation states would surrender power to a European government. Consistent with this view, his entire analysis is conducted on the basis of comparisons between states and the EU as such is entirely ignored.

For a citizen of the EU, such a view is shocking. We know that you cannot beat demography and we are used to hear dismissive views on our growth perspectives (in fact, we supply quite a lot of them ourselves), but we pretend to some form of existence and we are not accustomed of being altogether ignored. Even the most fiercely Eurosceptic concede the EU has achieved something – if only to claim it should be undone.

However, challenges have virtues. They force us to re-examine things and to question what has been taken for granted. I therefore wish to take this lecture as an occasion to reflect on the international economic role of the EU: its representation in international economic organisations; the way it uses the power it has; the involvement of the member states and the Union as such in this external representation; and the choices it faces.

This will give me the occasion to address an issue of immediate relevance. Political pressure has started to rise in favour of a reduction of Europe’s weight in international organisations. In the G20 meeting of October 2005, finance ministers agreed “that the governance structure of the Bretton Woods institutions - both quotas and representation - should reflect changes in economic weight” – meaning, the EU’s weight should be reduced. They set the deadline of achieving concrete progress on quota reform by the 2006 IMF and World Bank Annual Meetings. A few days before, the US Treasury lent support to a rebalancing of quotas in favour of emerging market economies and indicated that a consolidation of European chairs would “help to increase the relative voice of emerging markets and developing country members” (Adams, 2005). The system of external representation, and its relationship to policies, is thus becoming a concrete policy issue.

Focus on this topic will not allow me to address a more fundamental critique, namely that the EU as an entity is in fact irrelevant. Let me just say the following: coming from a country whose citizens recently rejected a proposal for a EU constitutional treaty, I am not inclined to underestimate the problems we are facing. Nevertheless, I think the degree of economic and political integration we have achieved is considerable: all border controls are past memory; EU law has precedence over national law; most of the economic legislation in force in our countries is now EU legislation; states are routinely fined in cases of non-compliance; competition policy cases are decided in Brussels; the euro, which has replaced the national currencies of twelve countries, is run by a federal central bank; we have a parliament and a sort of government. “Surrender of national power” has therefore taken place already to a considerable extent.

In what follows, I start by looking at Europe’s share in the distribution of power in international economic and financial institutions and discuss whether and where Europe is making use of this power to set the international agenda. Then I turn to discussing reasons why the EU refrains from using the power it has and examine whether that can be ascribed to preferences or to governance structures. Finally, I offer some policy implications in section 3.

## 1. The paradoxes of European power

### a. How well is the EU represented in international organisations?

Assume for a moment that an inhabitant of planet Mars is aiming to assess the distribution of power in international economic institutions on planet Earth. An informed and intelligent Martian would probably come up with something like Table 1.

**Table 1: Weight of the EU in international economic and financial institutions**

Institution	Number of members		Current-dollar GDP 2004 (Millions US dollars)		PPP-based GDP 2004		Population (Thousands)	
	EU Share	Total Share	EU Share	Total Share	EU Share	Total Share	EU Share	Total Share
<b>G7</b>	4 <b>57.1</b>	7 <b>100.0</b>	8,530,200 <b>33.1</b>	25,800,877 <b>100.0</b>	7,523,804 <b>31.5</b>	23,919,052 <b>100.0</b>	259,600 <b>36.4</b>	712,773 <b>100.0</b>
<b>G20**</b>	5 <b>25.0</b>	20 <b>100.0</b>	8,530,200 <b>26.3</b>	32,491,185 <b>100.0</b>	7,523,804 <b>17.7</b>	42,553,026 <b>100.0</b>	259,600 <b>6.5</b>	3,978,923 <b>100.0</b>
<b>OECD membership financing</b>	19 <b>63.3</b> <b>39.8</b>	30 <b>100.0</b> <b>100.0</b>	12,590,954 <b>38.3</b>	32,872,708 <b>100.0</b>	11,843,086 <b>37.1</b>	31,918,154 <b>100.0</b>	445,038 <b>38.4</b>	1,158,310 <b>100.0</b>
<b>IEA</b>	17 <b>65.4</b>	26 <b>100.0</b>	12,308,029 <b>38.6</b>	31,900,906 <b>100.0</b>	11,273,275 <b>37.2</b>	30,324,233 <b>100.0</b>	401,488 <b>39.7</b>	1,010,675 <b>100.0</b>
<b>IMF/WB* membership quotas control seats</b>	25 <b>13.6</b> <b>31.9</b> <b>33.6</b> <b>29.5</b>	184 <b>100.0</b>	12,690,643 <b>31.5</b>	40,285,680 <b>100.0</b>	12,001,028 <b>21.9</b>	54,739,393 <b>100.0</b>	455,297 <b>7.3</b>	6,249,771 <b>100.0</b>
<b>WTO**</b>	26 <b>17.6</b>	148 <b>100.0</b>	12,690,643 <b>32.7</b>	38,832,717 <b>100.0</b>	12,001,028 <b>23.5</b>	51,164,404 <b>100.0</b>	455,297 <b>8.2</b>	5,566,131 <b>100.0</b>
<i>memorandum</i> <b>UN membership financing</b>	25 <b>13.1</b> <b>36.5</b>	191 <b>100.0</b> <b>100.0</b>	12,690,643 <b>31.5</b>	40,285,680 <b>100.0</b>	12,001,028 <b>21.9</b>	54,739,393 <b>100.0</b>	455,297 <b>7.2</b>	6,284,014 <b>100.0</b>

(\*) For IMF and WB, "membership" gives the proportion of EU countries in total member countries, "votes" their share in the total quota-based votes, "control" the proportion of votes they control, assuming a country holding the chair controls the vote of its constituency, and "seats" the proportion of seats held by EU member countries in the Executive Board.

(\*\*) The G20 has 19 members, plus the EU as an institutional member. In the WTO, the "European Communities" are counted as a separate member.

Source for GDP and population: World Development Indicators database, World Bank, 15 July 2005

He would then note two basic facts.

First, that several international institutions – the Group of Seven, the OECD and the International Energy Agency – have a very Eurocentric membership. Thanks in part to the small average size of EU countries, European membership within these institutions accounts for far more than the share of the EU in total GDP or population. Looking at the details, the Martian observer would probably be astonished to learn that in G7 finance meetings, the EU commissioner for economic and financial affairs and the finance minister of the country holding the EU presidency participate in part, in addition to the ministers of finance of the four European members (France, Germany, Italy and the UK) and that the president of the European Central Bank replaces the three governors from the euro area countries for discussions on multilateral surveillance. He would also note that another European country, Russia, is slowly making its way towards becoming a full member of the G7<sup>1</sup> - and conclude that the EU should be playing the key role in the G7.

Our Martian would note that an exception to this Eurocentric pattern is the Group of Twenty<sup>2</sup>, (an informal forum created in 2000 that includes the ministers of finance of the G7 members, Australia and eleven emerging countries, plus the EU) but as he might learn, this grouping was created precisely to correct the prevailing bias in the G7 and to engage the major emerging countries in an informal economic dialogue. Nevertheless, with four country members and a representation as an entity, the EU is well represented in the G20.

Second, turning to global institutions like the World Trade Organisation (WTO) or the Bretton Woods institutions, our Martian could observe that the EU accounts for a significant share of their membership: 26 (the 25 member states plus the EU as a separate entity) out of 148 WTO members and 25 out of 184 IMF / WB members.

There is no weighting of votes (and there are no votes) in the WTO but there is one in the Bretton Woods institutions. Our Martian would thus devote some efforts to assessing the weight of the EU in those institutions as there are several ways to measure it, but having understood their intricate governance structure, he would conclude that they converge to assess the voting weight of the EU at about 30%. This is, he would note, in line with the share of the EU in the current-dollar world GDP but significantly more than its share in PPP-based world GDP or population. It is also far above the 17 % quota of the US and the 15% blocking minority.

Martians have a reputation for being good mathematicians. With some maths and the help of a computer, our observer could compute the true power of the EU: its Banzhaf voting power index – that is, the frequency with which it is the swing voter when behaving as a block. He would then conclude, as did Lorenzo Bini Smaghi (2005) in a recent paper, that the potential power of the EU25 in the IMF is 50% higher than its voting weight. If they were to form a coalition, the EU countries would by far be the dominant power in the IMF with a voting power index of 48% - the next one being the US with 7%.

Talking to insiders, the Martian would learn a few additional facts: first, that being by tradition a European, the Managing Director of the IMF is in fact designated by the EU<sup>3</sup>;

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<sup>1</sup> Russia is not included in Table 1 calculations.

<sup>2</sup> I am referring here to the finance G-20. There is also a trade G20, which has formed on the occasion of the Doha round, and is exclusively composed of emerging and developing countries. They happen to have the same number of members, hence the same name.

<sup>3</sup> Intra-EU coordination on the choice of a candidate has gradually increased. The current MD, Rodrigo Rato, was designated by the EU. His predecessor, Horst Köhler, was appointed after another German candidate, Caio Koch Weser, had been vetoed by the US administration. On this occasion there was an attempt to break with the tradition and propose for candidate Stanley Fischer, at that time a US citizen, but his candidacy did not go far.

second, that the G7 routinely behaves as a caucus within the International Financial Institutions and that since it represents 46% of the vote in those institutions, its positions hold considerable clout. From that, he would certainly deduce that the power of the EU goes beyond its formal voting power.

Our Martian would presumably conclude that the EU is the clear winner in the distribution of international institutional power. In fact, this observation has not escaped some inhabitants of planet Earth. For example, Vijay Kelkar and co-authors (2005) note that the combined votes of Brazil, China and India in the Bretton Woods institutions are about 20% below those of Italy, Belgium and the Netherlands, while their combined GDPs at market exchange rates are 23 percent higher, their combined GDPs at PPP exchange rates are four times higher, and their populations are 29 times higher<sup>4</sup>. These are astonishing figures, which may explain why the Asian countries feel so little ownership in the Bretton Woods institutions.

Assuming he had some kind of Marxist background, our Martian would carry on his investigation and look at the power of money. He would then note that the EU member states provide between 30 and 40% of the financing of international institutions. He would also look at the financing of development and observe that in 2004, the members of the EU provided 43 billion US dollars in official development assistance out of a total of 79 billion<sup>5</sup>. He would also observe that in addition to having two development banks of their own (the European Investment Bank and the European Bank for Reconstruction and Development), they participate in the African, Asian and Latin American regional development banks.

Having observed that the EU combines the power of number, the voting power and the power of money, our Martian would presumably conclude that it is the dominant player in the international economic and financial game – meaning, that it holds the agenda-setting power and is in a position to assemble majorities that support its views.

The next question our Martian would ask himself is whether the EU makes use of its institutional power to set, or at least to shape the architecture of the multilateral system, to determine the agenda of the discussions, to broker deals that correspond to its objectives, and to influence decisions.

Answering that question is however much more difficult as it implies relying on case-by-case observations and on the testimonies of the inhabitants of planet Earth.

### ***b. Is the EU an agenda setter ?***

To hold voting power in international organisations does not necessarily mean being an effective power. Indeed, three years ago, the Europeans were shocked by the publication of a paper by Robert Kagan (2002) entitled *Power and Weakness*. Kagan's main thesis was that it was time to realise that Europeans and Americans did not share a common view of the world. Europe, he said, "is turning away from power, [...] it is moving beyond power into a self-contained world of laws and rules and transnational negotiation and cooperation".

The Europeans however were quick to take some comfort from a book by another US foreign policy scholar, Joseph Nye (2002), whose thesis was rather that the world is moving in Europe's direction. International power, he said, does not need to rest on force and be discretionary. It can be based on, and draw legitimacy from, commonly agreed rules. In short, there can be something called *soft power*.

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<sup>4</sup> Quoted in Truman (2005).

<sup>5</sup> Source : OECD DAC data for 2004.

This was exactly what the Europeans wanted to hear. Being a soft power could reconcile the aspiration to be a world role and the aversion to force. Competition commissioner Mario Monti – who, while playing by the rules, was soon to block the merger of US giants GE and Honeywell– and trade commissioner Pascal Lamy became the incarnations of this new kind of civilised international power.

There is considerable truth in this characterisation. In international economics as elsewhere, the EU is the champion of rules (Laïdi, 2005). The reason for that is straightforward: it is itself based on rules. The entire history of European integration can be looked at as a patient yet consistent attempt at rebuilding intra-European relations on the basis of a system of law, rules and decision-making procedures. It is therefore quite natural for it to envisage international relations in the same way and to champion global governance. Hence, for example, the EU's active role in the creation of the International Criminal Court, the WTO, or the Kyoto protocol on global warming. The US, by contrast, remains suspicious of any international constraint that would bind the exercise of discretionary power. In the words of George W. Bush, it does not accept having to ask for a “permission slip” before taking decisions.

But is the EU *really* a soft power? Does it have a vision of the world and an agenda? Does it play the power game within institutions? Or does it only take comfort in an oxymoronic characterisation of what it pretends to be?

To answer these questions and assess the role the EU has been able to play, topics have to be taken one by one. Providing a comprehensive and systematic assessment would require very substantial research. Here, I will only survey three domains in a cursory and admittedly impressionistic way: international trade; exchange rates and macroeconomic surveillance; and international finance.

### Trade

The EU is without any doubt a major player in the international trade negotiations. It has clearly stated priorities – including, you may think, disputable ones – and the ability to push for them. Together with the US, it has in fact steered the successive international discussions on multilateral trade liberalisation.

In the “legacy” paper he posted at the end of his mandate as trade commissioner, Pascal Lamy claimed that “The lesson to be taken from the experience of the past five years is that, when it chooses to pursue a truly federal policy, the EU can play a decisive role on the world stage. Together, we have a far greater ‘weight’ than the sum of the Member States. We have the ability, not only to resist initiatives that we do not support [...], but also to set the international agenda. The priority given to development in the Doha Agenda, or the agreement on medicines are evidence of this pivotal European role” (Lamy, 2004).

There is perhaps a degree of exaggeration in this self-assessment. The failure of the Cancun ministerial conference and the EU's inability to make the Singapore topics an essential part of the Doha round are useful reminders of the limits to European power. Nevertheless, Europe is a strong player and interestingly, its power seems able to survive changes in negotiation arrangements. The failure of Cancun was widely attributed to an underestimation by the incumbents (the industrialised countries) of the rising weight of emerging countries. Having reached a bilateral deal on agriculture, the US and the EU had not properly assessed the difficulty of reaching an agreement with the other players.

However, the Lamy legacy paper notes that the “Quad” – the informal group formed by the US, the EU, Japan and Canada that had been playing a steering role in the previous trade rounds – met for 20 minutes only during the 1999-2004 stint of the Prodi commission. In lieu

of this has come what the paper describes as “a flexible feast of mini and micro Ministerials, ad hoc small groupings, always with EU, US, Brazil and India at the core”. In other words, the rise of emerging countries has not led to a diminished EU role but rather to a de facto replacement of Japan and Canada by Brazil and India.

Turning to substance, today’s international trade architecture owes a lot to the EU. As already mentioned, the creation of the WTO was the crowning achievement of its sustained effort to strengthen the multilateral system. However, and somewhat paradoxically, the EU is also the inventor of trade regionalism. It is itself a regional block and has actively promoted the creation of regional trade arrangements. Trade scholars are thus generally struck by the complexity of its actual policy, especially by its combination of regional and multilateral approaches. Why, for example, does the EU have preferential trade agreements with virtually all countries in the world? What is the rationale for having special trade agreements with both close neighbours and distant partners, rich and poor countries, competitors and protégés? How does that relate to its stated support for multilateralism? Why does it oscillate between multilateralism and regionalism?

The lack of clear answers to those questions is an indication of the limits to the EU’s ability to develop a consistent strategy. But here again, the EU has for better or worse been providing leadership.

#### International macroeconomics

There are many reasons why the EU should be a key player in international macroeconomic and exchange rate affairs.

First of all, Europe has made a major economic and institutional investment in the creation of a common currency and the setting-up of supporting institutions. While the motivations for the creation of the euro were in large part internal, the expectation that it would become a major international currency also played its role – I suspect even a prominent one in the case of some of the proponents of the European currency.

Second, having a common currency has strong implications for policymaking. It implies that the balance of payments and the exchange rate become collective goods and must therefore be managed jointly – if at all managed.

Third, the EU still accounts for one-third of world GDP at current exchange rates and one-fifth at PPP exchange rates. Its main currencies, the euro and the pound sterling, rank number two and four in international currency transactions. The EU also holds very significant external assets and liabilities. According to Philip Lane and Gian Maria Milesi-Ferretti (2004), in the period since the creation of the euro, gross capital flows from and to the euro area have actually been higher than for the US – 7.2 trillion US dollars in 1999-2003 against 6.1 trillion for the US.

Therefore, the EU and/or the euro area have undoubtedly a major stake in the international monetary system. However, since the launch of the euro, neither the EU as a whole nor the euro area has expressed any strong intention to build on it to enhance their international role.

On the institutional side, there has been no major reshuffle in the external representation of the euro area after 1999 – in spite of numerous and long-standing proposals from academic circles and obviously from the European commission.

On substance, the Europeans have remained soft-spoken or even silent on global issues. In stark contrast to the US, they have not expressed strong views on issues such as the unwinding of current account imbalances or the Chinese exchange rate. On the euro-dollar exchange rate, several mutually inconsistent opinions have frequently been expressed by the

ministers of finance and central bank governors. On the nature and speed of the US current account adjustment, Europeans have more than once given the impression that their best hope was for a preservation of the exchange rate status quo – while routinely exhorting the US to fiscal discipline and a correction of the external deficit. On the Chinese exchange rates, they have not expressed specific views – although their interest may differ substantially from that of the US.

In short, European policymakers seem to have de facto refrained from drawing the conclusions from the world status of their currency.

### International finance

The IMF and World Bank boards very rarely go to vote. Rather, the chair proposes conclusions based on its reading of the majority view, and decisions are then adopted by consensus. No formal analysis of the votes is therefore possible and one must draw on the analysis of episodes and actual decisions.

The years since the 1994 Mexican crisis and even more since the 1997-1998 Asian crisis have been characterised by an intense discussion on the reform of the international financial architecture. Although the frequency and intensity of crises have abated since the Argentine meltdown of 2002, the discussion is not over, as illustrated by the strategic review of the International Monetary Fund that is being prepared and is expected to be examined in 2006. Major issues have been and still are on the agenda such as the resolution of financial crises, the role of the IMF and the World Bank, or the scope for regional arrangements, especially in Asia.

The Europeans have certainly been part of the discussion within the G7, the G20, the Bretton Woods institutions and in public forums, and they may claim some successes such as the partial reform of IMF governance through the creation of the International Monetary and Financial Committee (IMFC) or the so-called involvement of the private sector in crisis resolution.

However, careful analysis of the discussion shows that they have rarely set the agenda. They have often responded to new developments in a reactive mode, slowly adapting to events and adjusting to new (frequently US) proposals, and have almost never pushed for radical new ideas. In a paper I wrote in 2000 with Benoît Coeuré, our conclusion was that the US had behaved throughout the financial crises as the (mostly, but not exclusively benevolent) hegemon of international finance, and that Europe had not behaved as the world monetary and financial power it could be and sometimes pretended to be. Developments since that paper was written do not lead me to change this conclusion.

Riccardo Faini, a former Executive Director with the IMF, and Enzo Grilli (2004) have attempted to measure quantitatively the influence of the US, the EU and Japan in the IMF and World Bank decisions by assessing whether the geographical lending pattern of those institutions reflects their respective bilateral trade of financial relations patterns. Their results suggest that the US and the EU are both influential, but the former more than the latter. They especially contrast the importance of both trade and financial links for the US with the absence of any discernable influence of the EU's financial links. This is an admittedly rather indirect measure that is subject to technical discussion, but it corresponds well to the casual observation that the US financial community is much more concerned by, and vocal on IMF issues than the European one.

Here again, therefore, the EU's effective role does not seem to be commensurate with the potential role its representation in the Bretton Woods organisations could allow it to play.



Summing up, there is a striking contrast between Europe's formal power in international organisations and forums and the less prominent role it plays in substantive international discussions – with the exception of trade matters. The question, thus, is why Europe does not really make use of the institutional power it has.

## **2. Why does Europe refrain from using its power?**

### ***a. Hypotheses***

The first potential explanations for this contrast are *disinterest* and *distraction*. Europeans are perhaps happy not to be excessively involved in world governance and to free-ride on a presumably benevolent US hegemony. Or they may be occupied by domestic and regional affairs.

There is certainly some truth in those hypotheses. The median voter in the EU-25 member country is a small open economy that is used to taking the state of the world as given instead of trying to change it according to its preference or its interest. It is also undisputable that since the launch of the Single Market programme in the mid-1980s, the EU has been busy dealing with its twin processes of deepening and widening as well as with the corresponding reforms of its institutions and governance – not to speak of the domestic economic reforms. Most of the senior policymakers' energy has in fact been devoted to this internal agenda, with the consequence that global changes have sometimes been overlooked in the process.

However, it is hard to be fully convinced by such explanations. To begin with, not all member states share the small-country culture and the EU as a whole is without doubt a very large entity. As to the distraction hypothesis, it may have played a role temporarily but it cannot account for a permanent behaviour. At any rate, if this were the main explanation for Europe's intermittent international presence, the EU can be expected to become more assertive on the external front if and when it solves its internal difficulties.

A related possibility is that the EU is not equipped with the same intellectual firepower as the US. Benoît Coeuré and I have observed that in the discussion on the reform of the international financial architecture of the late 1990s and early 2000s, the US authorities had constantly drawn on new ideas and proposals emanating from the research community. A similar pattern has emerged on issues such as the global current account imbalances or China's exchange rate regime, which have become more frequently than in Europe the topic of policy-oriented academic research. However, the supply of policy research cannot be regarded as exogenous. A major reason why the field is less active in Europe is that there is much less demand from, and interaction with, the community of policymakers<sup>6</sup>.

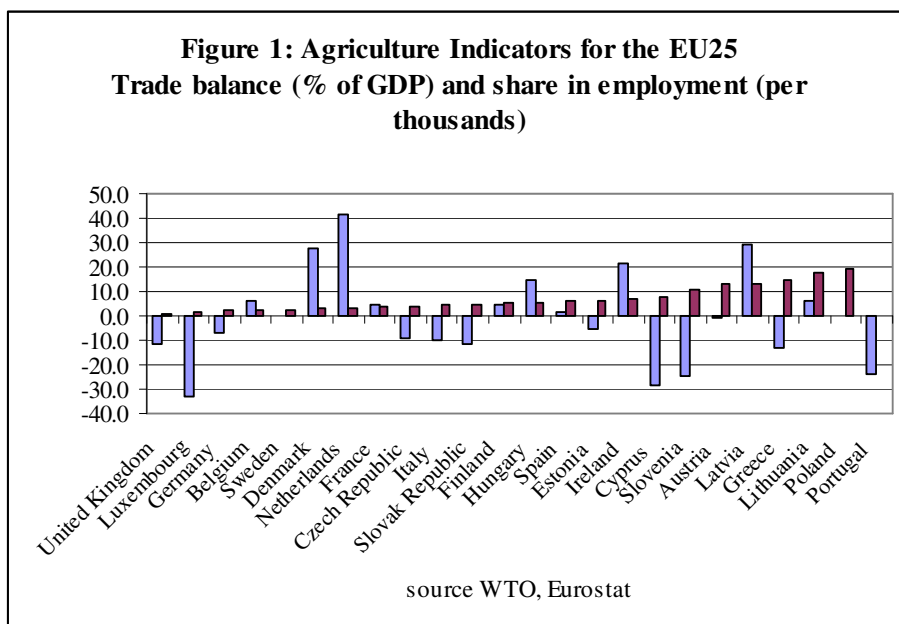
This leaves us with two main hypothesis. One is that the EU is divided because preferences differ among its constituent member states. The other is dysfunctional governance.

The preference heterogeneity argument has weight. Within an increasingly diverse EU, there are many reasons why preferences should differ and there is none to believe that this diversity does not affect international economic relations. From intellectual and policy traditions to degrees of openness and patterns of trade and financial integration of the world economy, several factors can explain why the EU countries can have difficulties reaching common ground on global matters.

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<sup>6</sup> Jaume Ventura has pointed out to me that European economists have in fact been very active in research on global imbalances – though mostly through US research institutions like the NBER. This is a clear indication that the EU does not lack the intellectual ability to address global issues.

However, this is also true for international trade – and even more so. From development levels and specialisation patterns to the functioning of labour markets and to domestic political institutions, there is every reason to consider that the economics and the political economy of trade liberalisation differ widely within the EU. The case of agriculture is especially striking (Figure 1): the EU includes all varieties of situations – and therefore all kinds of preferences – but it *does* have a common policy for agricultural trade.



The same is actually true in the US. A well-known stylised fact is that the regional specialisation is more pronounced within the US than within the EU. Hence, from a political economy standpoint one can suspect a higher degree of trade preference heterogeneity among US states than among EU countries.

This leads to the *dysfunctional governance* hypothesis. The EU has put in place very complex and diverse arrangements for organising its international economic and financial relations with the rest of the world. In some fields, policy responsibility is fully delegated to an EU institution – in practice, the Commission or the ECB – which has been given a clear mandate to act. In others, responsibility is divided between member states and they only endeavour to coordinate their views. It could thus be the inefficiency of some of its governance mechanisms that prevents the EU from playing the role it could play.

This is clearly the interpretation suggested by Pascal Lamy when speaking of the EU’s ability to play the role of an agenda-setter. This is also the one proposed by Lorenzo Bini-Smaghi, who prior to his appointment to the board of the European central bank played a key role in the coordination of European positions in international monetary and financial affairs. He said: “If EU countries wish to improve their collective influence in international issues and the IMF, some institutional changes in the way European interests are represented and promulgated may be necessary” (Bini Smaghi, 2004). If this is the right explanation, the EU first and foremost needs to reform its external representation in the fields where it is not effective.

This is where Arvind Virmani strikes back. The reason why the EU is not a full power may have to do with the degree to which member states of the EU stand ready to accept a

federalisation of international economic policy. A closer look at the governance of international relations in the EU is therefore required.

**b. Alternative models of governance**

As already indicated, the EU does not rely on a single template for organising its external economic relations. On the contrary, depending on the field responsibility for them can be assigned to the EU, to the member states or jointly to both levels. However, there is a limited number of underlying models. Table 2, which draws on Coeuré and Pisani-Ferry (2003), provides a rationalisation for the existing arrangements. We can distinguish:

- an *unconditional delegation* model, in which the member states fully and unconditionally delegate a policy responsibility to an EU institution;
- a *supervised delegation* model, in which they delegate representation and negotiation authority while retaining control rights (the EU body can then be considered an agent and the member states multiple principals). The standard case here is trade, where the Commission has delegation but is given a mandate by, and is accountable to, a committee formed of representatives of the member states;
- a *coordination model*, in which member states simply commit to coordination while retaining their prerogatives. This is the model in use for the G7 and the international financial institutions.

**Table 2: Governance models in EU external economic relations**

Model	Main features	Examples
Unconditional delegation	Policy responsibility delegated to EU institution	Competition policy (subject to appeal to ECJ)
	Monitoring by MS, if any, not binding on decisions by EU institution	ECB exchange rate policy (monitoring by Parliament)
Supervised delegation	External representation and negotiation authority delegated to EU institution	Trade in goods and services
	MS exercise surveillance: issue guidelines and monitor implementation	Market regulation Environment
Coordination	No delegation of external representation to EU institution.	International macroeconomics
	MS coordinate among themselves and with EU institutions, may or may not commit to follow guidelines.	International finance

As a matter of principle, none of the three models is intrinsically superior. Federalists have a preference for unconditional delegation, but it raises issues of accountability, especially when the mandate is broad and the performance not easily observable. Supervised delegation is a compromise that combines accountability to the principals and centralisation in implementation. Coordination has virtues when externalities are limited or depend on the issue that is being addressed.

A good way to assess these models is to look at them through the lenses of the theory of contracts – with the EU states playing the role of multi-principals and the body in charge of common policy that of an agent. This leads us to conclude that the choice for a particular one depends on externalities, preferences, the cost of acquiring decision-relevant information and

the ability of the principals to monitor the agent, as well as on the distributional risks involved in majority voting<sup>7</sup>.

From this perspective, supervised and unconditional delegation each have virtues – as for the choice between decision by elected politicians and delegation to an independent agency. But there are few arguments to prefer coordination to supervised delegation in the field of external economic and financial relations, where externalities are large and economies of scale significant. Quite apart from the power game in international institutions, independent participation in global governance accompanied by a loose intra-EU coordination mechanism discourages national governments from investing in the acquisition of relevant information, from trading-off short-term benefits for long-term gains and from resisting special interest groups. It encourages cajoling special interests and popular beliefs at home, or investing political energy on narrow issues, while free-riding on the more important ones. Those are in fact behaviours that can be observed in this field.

The advantage of supervised delegation over coordination is that it allows the member states to internalise externalities while retaining control of the mandate given to their agent in international institutions. It is a flexible mechanism that does not lead to transferring complete control to the EU level and retains a steering role for the member states.

Summing up, the choice for the EU is not between complete centralisation and complete decentralisation. Supervised delegation is a workable model that has been used for a long time in the trade field and provides a reasonable compromise between accountability and efficiency.

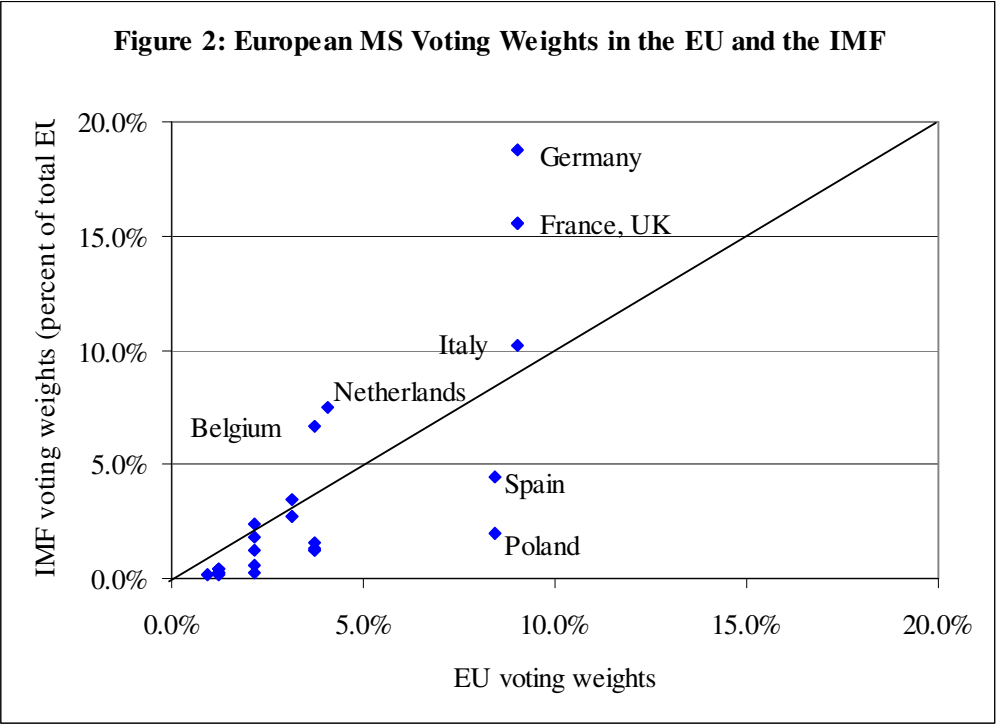
The question is, then, why has the EU not adopted this model across the board? The reason is quite straightforward: moving to supervised delegation does raise a significant difficulty as it affects the balance of power within the EU.

In the field of international macroeconomics, the bigger member states – those who belong to the G7 – hold a de facto monopoly of external representation. They are not keen on surrendering it, as it would not only imply delegating power to the EU but also sharing supervision with the smaller member states, which have virtually no say at present. Furthermore, the G7 is a flexible forum without a predetermined mandate that can address a very wide range of issues. This does not fit well with the governance model of the EU, which assigns specific responsibilities to the EU level.

As for the Bretton Woods institutions and the field of international finance, Figure 2 gives relative voting weights within the EU (according to the Nice voting system) and the IMF. It suggests that the major losers in the adoption of a supervised delegation model would again be the bigger countries: Germany, the UK and France, whose current weights within the EU representation at the IMF significantly exceed their weights within the EU.

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<sup>7</sup> Maskin and Tirole (2001) are a useful reference.



Other potential losers are the Netherlands and Belgium, which both are significantly overweighted and both hold a chair at the Executive Board of the IMF. In fact, the prestige attached to chairing a constituency is a further obstacle to a consolidated EU representation. This helps explain why the situation has remained unchanged until now.

Summing up, the transfer of international representation to the EU would involve an internal redistribution of power, not only from the states to the EU level – this could be lessened through appropriate supervision mechanisms that would leave control rights in the hands of the member states – but among the member states. This internal dimension of the power game certainly plays a significant role in the maintenance of the status quo.

**3. Policy implications**

Let me now turn to the policy implications of this analysis.

The situation I have described is one of over-representation and under-effectiveness of the EU in international economic relations. I think that this combination is increasingly unsustainable and that calls for a change cannot and should not be resisted any more.

It is unsustainable, first, because the only way the EU could justify remaining the winner in the distribution of formal power is by behaving like a benevolent hegemon – that is, by providing a public good that would lead the other players to accept its dominance. As developed above, the muted role the EU plays in substantive international discussions does not justify an overrepresentation.

It is unsustainable, second, because reform of the global economic and financial institutions and the rebalancing of power it implies are not simply required for the sake of fairness. More importantly, they are necessary to ensure a sufficient degree of ownership in the multilateral system. The EU has every interest to ensure that all countries share ownership in the

multilateral system. The more imbalanced this system is, the stronger the temptation will be for those who feel underrepresented to look for alternative solutions. Increasingly, East Asian countries express interest in regional rather than multilateral cooperation. They also count on self-insurance through the accumulation of reserves instead of relying on international financial institutions. This behaviour has the potential to severely undermine the multilateral system – but it is understandable as long as East Asia feels that system is unfairly dominated by others.

It is unsustainable, finally, because Europe's interests call for a change. Pressure has begun to mount for a redistribution. The Europeans are tempted to postpone it, if only because they do not know how to redistribute power among themselves. Even from an entirely selfish viewpoint, this would be a mistake. Europe's share in world GDP is rapidly declining as a consequence of its demography and of the accelerated development of major emerging countries. It is bound to decline further – and rather fast. The more the adjustment is delayed, the lesser the weight of Europe will be in the international institutions.

This adjustment does not need to involve the EU only. For example, Saudi Arabia is currently over-represented in the IMF with a quota that exceeds that of India, and the same applies to some other oil producers. But this also calls for taking the initiative because the earlier the EU accepts the need for change, the more able it will be to call for a general review of representations and quotas.

The EU needs to trade off formal, but partially ineffective power for a formally diminished, but more effective influence in world economic affairs. For this to happen, it must seize the opportunity of the calls for a rebalancing of representations in the IMF and other institutions and grouping and reform its own external representation. This does not necessarily imply a complete federalisation of external representation, which would not correspond to existing internal arrangements and for that reason would not be effective. The supervised delegation model in use in the trade field offers a middle way. It allows member states to retain control rights through the definition of a mandate and the supervision of its implementation.

The main difficulty the EU has to solve is the internal redistribution of power that will follow a redefinition of its external representation. This is an admittedly complex issue, which involves at least as much concerns about prestige, as about effective power. However, this is hardly a valid excuse for inaction – unless the EU wants to demonstrate that it does not deserve the power it has. Fortunately, the multiplicity of institutions and forums offers an opportunity for compromise. For it to be found, action has to start.

#### **4. Conclusions**

I started this lecture with the remark that challenges have virtues. I hope I have shown you that this is indeed the case and that the image of the future offered by Arvind Virmani in his thought-provoking paper is for an European an opportunity to revisit the achievements that are often taken for granted.

I am not sure I have been able to convince Arvind Virmani that he was wrong to discard the EU as a player in the world economy of the XXI<sup>st</sup> century. From what I have said, he may even conclude that he was in fact right.

We are in fact not that far from each other. He claims the EU is not a player in the world economy. I think it should rather be characterised as an accidental player – one which, depending on its internal arrangements or the lack of them, is sometimes at the table and sometimes off the table.

What I wish to stress is that in the XXI<sup>st</sup> century, the Europeans will not any more be able to afford the luxury of this strange position. The choice for them is to be part of the game or to be absent from it. The earlier they choose, the more able they will be to build on the vast formal power they still have in international organisation to exert an effective international influence.

It is therefore more than time for the EU to move away from the status of an accidental player.

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