Evidence on Economic and Monetary Policy for the Balance of Competences Review

Dr Dermot Hodson[1]
Senior Lecturer in Political Economy
Birkbeck College
University of London

Does the economic governance system provide the appropriate balance of competence between the European Commission and the Council?

The European Union (EU) should, and by and large does, tread carefully in relation to economic governance. The smooth functioning of the single currency requires a close coordination of member states' economic policies, as the devastating effect of macroeconomic imbalances within the euro area in the wake of the global financial crisis demonstrated all too clearly. Yet there are serious economic risks to imposing a one-size-fits all policy on heterogeneous economies and legitimate political concerns about European involvement in such a sensitive area of policy-making. For these reasons, the EU has traditionally avoided the classic Community method of policy-making in this domain in favour of softer forms of policy coordination. The Community method relies on the delegation of significant agenda setting and/or implementation powers to the European Commission (Dehousse, 2011). Policy coordination, in contrast, relies on the Commission and ECOFIN to encourage peer pressure and consensus building but leaves the first and final say over policy decisions in the hands of the individual member states (Hodson and Maher, 2001).

In spite of the extensive reforms enacted since 2010, EU economic governance essentially remains an exercise in policy coordination (Hodson, 2015). While these reforms have strengthened the Commission's hands vis-à-vis the Council of Ministers, most noticeably through the introduction of reverse majority voting for certain steps under the stability and growth pact, national governments have not ceded new competences in relation to economic governance. That national governments still exercise significant discretion as a result has been evident in the early experience of implementing the six-pack. A case in point is the treatment of Belgium, which moved a step closer in July 2013 to financial penalties after EU finance ministers agreed to give notice to this member state to undertake specific measures to reduce government borrowing below 3.0% of GDP. In November 2013, EU finance ministers concluded that Belgium had taken sufficient steps in this direction and that further disciplinary measures were not envisaged at this stage. For all the talk of pecuniary sanctions under the six-pack, in other words, peer pressure remains the norm.

What is the appropriate role of the European Parliament in economic governance?

The Treaty assigns the European Parliament a limited role in EU economic governance. Under Articles 121 and 126 of the Treaty on the Functioning of the European Union (TFEU), Parliament is kept informed of Council guidelines on member states' economic policies, multilateral surveillance efforts and decisions

[1] The views expressed in this note are strictly personal and should not be attributed to Birkbeck College.

taken in relation to the excessive deficit procedure, but it is not given a substantive role. Changes to the rules underpinning multilateral surveillance are, since the Lisbon Treaty took effect, decided on the basis of the ordinary legislative procedure.[2] The Parliament made the most of this provision during negotiations over the six-pack and two-pack to ensure that it was involved as a co-legislator over key EU economic reforms even in areas not expressly provided for under the Treaty.

Whether the European Parliament brought greater legitimacy to this reform process as a result is a matter of debate, but it did allow Members of the European Parliament to gain greater visibility in relation to EU economic governance. This included the creation of an Economic Dialogue to allow the Commission to present its economic analysis and surveillance efforts before the European Parliament with representatives of the Eurogroup and European Council also in attendance.[3] This is a welcome move as the Commission has sometimes struggled to communicate its key messages on EU economic governance in ways that reach a broad audience. The European Parliament can be an important platform for EU policy makers, as evidenced by media interest in the Monetary Dialogue, a high profile forum in which senior members of the ECB meet with members of the European Parliament's Economic and Monetary Affairs Committee to discuss monetary policy matters.

What do you consider to be the most appropriate role for National Parliaments in the economic governance system?

Aside from their role within national systems of economic governance, national parliaments have a major part to play in scrutinising EU economic governance. Research in the early years of EMU showed stability and convergence programmes, which set out member states' medium-term fiscal plans in compliance with the stability and growth pact, were generally submitted to the ECOFIN Council without prior endorsement from national parliaments (Linsenmann, 2003). It came as little surprise, therefore, that member states' medium-term budgetary plans lacked credibility. A related problem at this stage was the timing of the EU economic surveillance calendar. Stability Programmes were frequently submitted after member states had taken key decisions on expenditure and taxation for the year ahead.

The introduction of the European Semester is a welcome move in this regard (see below). The engagement of national parliaments in the oversight of EU economic governance remains patchy nonetheless. In a survey of the European Semester 2013, Claeys et al. (2013) found that 14 out of 25 member states had either failed to consult or failed to report on consultation with national parliaments over stability and convergence programmes. This lack of engagement by and with national parliaments undermines both the credibility and legitimacy of EU economic governance and reduces national ownership over medium-term budgetary plans. It also makes it easier for national governments to deflect criticism from the Commission and ECOFIN by claiming outside interference from Brussels rather than explaining why policy commitments that member states signed up to in stability programmes have not been enforced.

[2] Article 294 TFEU

[3] Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area

Does the current governance structure strike the right balance between institutions of the euro area (EWG, Eurogroup) and those of the European Union (EFC, ECOFIN)?

Recent reforms have strengthened the Eurogroup relative to ECOFIN but the latter's influence over EU economic governance has been waning for some time. The Eurogroup was established in 1997 to encourage an informal exchange of views between euro area members on shared policy concerns. It originated, in part, from a sense of frustration with the ECOFIN Council, which was a large and unwieldy body with significant legislative responsibilities (Puetter, 2006). Initially, the Eurogroup took place in the margins of ECOFIN, but it gradually emerged as an institution in its own right with de facto decision-making responsibilities in relation to euro area governance (Hodson 2011: Chapter 3). An early indication of this fact was the leadership role played by the Eurogroup in negotiations over the reform of the stability and growth pact in 2005. The Lisbon Treaty reinforced the Eurogroup's role by giving it a legal status (of sorts)[4] and by allowing euro area members to press ahead with plans for closer economic policy coordination without the involvement of other EU member states. Reforms to EU economic governance in the light of the sovereign debt crisis saw euro area members put these provisions into effect for the first time through the euro-specific provisions of the six-pack and the two-pack.

There are political pros and cons to the Eurogroup's rise at the expense of ECOFIN. On the one hand, ECOFIN was ill-suited to the task of overseeing euro area governance for the reasons noted above. On the other hand, the Eurogroup's ambiguous position within the EU's institutional architecture raises concerns over procedural legitimacy in EU economic governance. Whereas ECOFIN is subject to certain legal requirements regarding transparency[5] and cooperation with other EU institutions,[6] the Eurogroup is bound by no such obligations. Recognising the Eurogroup as a configuration of the Council of Ministers would help to address these concerns in the long-term. In the short-term, inviting the ECOFIN President and Chair of the European Parliament's Economic and Monetary Affairs Committee to attend meetings of the Eurogroup would be a good start.

What evidence is there of the indirect impact on the UK of economic and monetary union and the relevant EU competences exercised over euro area Member States?

The euro area is by far the UK's largest trading partner so the impact of EMU on the British economy is profound. In macroeconomic terms, whatever doubts may exist about the ability of the UK and euro area to form an optimum currency area (Bayoumi and Eichengreen, 1997), the two economies are highly synchronised. Weyerstrass et al. (2011) find that the degree of synchronisation between the UK and euro area business cycles is higher than it is for many Central and Eastern European member states that one day plan to join the euro area. Altavilla (2004), meanwhile, finds that the UK business cycle has become more synchronised with the euro area than the United States since 1992. In financial terms, the UK is highly integrated with the euro area. According to the Bank of England's Financial Stability Report in June 2014, the exposure of major UK banks to so-called vulnerable euro area periphery economies

[4] Protocol 14, TFEU
[5] Article 16 TEU
[6] Article 13 TEU

remains in the region of £140 billion (Bank of England, 2014). Such exposure was higher still during the period of heightened turmoil over the euro area sovereign debt crisis in 2012. As a result, the UK was judged at this time to be the economy with the highest degree of vulnerability to the euro crisis outside the euro area itself.[7] In view of this macroeconomic and financial interdependence, it is in the UK's economic interest see a successful EMU underpinned by a well-functioning system of economic governance.

In spite of these economic arguments, the UK government has been ambivalent over the years in its support for EU economic governance, particular when it involves guidelines and recommendations on British economic policy. During his tenure as Chancellor of the Exchequer, Gordon Brown consistently pushed back against efforts by the Commission to encourage a more prudent course of government borrowing,[8] even though greater prudence would, in retrospect, have left the UK better placed for dealing with the fiscal aftermath of the global financial crisis. More recently, Vince Cable dismissed[9] calls by the Commission, in its annual recommendation on the UK's national reform programme, to 'deploy appropriate measures to respond to the rapid increases in property prices' (Commission, 2014), a matter of days before the Secretary of State for Business, Innovation and Skills issued similar concerns about the UK housing market.[10] Such defensiveness is understandable given the sensitivities surrounding the UK's membership of the EU, but it is at the same time harmful to the credibility of economic policy coordination by the Commission and ECOFIN. In view of these concerns, there is a case to be made for scaling back the UK's obligations in future reforms of EU economic governance.

What are the advantages and disadvantages of the current framework for coordinating economic policy through the European Semester?

Under the European Semester ECOFIN has a chance to comment on member states' medium-term fiscal plans before national budgets have been presented to national parliaments. This is a welcome move from the point of view of the credibility of EU economic governance because it allows the Commission and ECOFIN to intervene in debates about national economic policy before decisions on expenditure, taxation and economic reform have been set in stone. Whether such credibility comes at a cost for the legitimacy of EU economic governance is a matter of debate, however. Critics of the European Semester have expressed concern about the circumvention of democratic checks and balances over the national budgetary process (Tsoukalis 2011: 29). Such criticisms are overstated insofar as the European Semester relies on peer pressure and consensus building rather than legally binding commitments but EU policy-makers should take care to avoid the impression of bureaucratic overreach in this domain. Inviting the Commissioner for Economic and Monetary Affairs, the Eurogroup President and the ECOFIN President to make routine appearances before

[7] See Maplecroft's Eurozone Exposure Index 2012. Press release available at: http://maplecroft.com/about/news/eurozone-exposure-index.html

[8] See, for example, Brown's statement on the Pre-Budget Report in March 2004. Full text available at: http://www.theguardian.com/money/2004/mar/17/budget.budget20044

[9] BBC News (2014) 'European Commission urges UK to tax expensive homes more', 3 June. See: http://www.bbc.co.uk/news/uk-politics-27675294

[10] BBC News (2014) 'Vince Cable: Housing boom 'needs stopping', 12 June: See: http://www.bbc.co.uk/news/business-27809536

national parliaments to explain the economic rationale for country-specific recommendations issued under EU economic governance would be a welcome move in this regard.

Do you consider that the Macroeconomic Imbalances Procedure is an appropriate system for detecting and correcting underlying economic imbalances?

The Macroeconomic Imbalance Procedure leaves EU policy-makers in a much stronger position to detect underlying economic imbalances. The European Commission's warnings against such imbalances in advance of the global financial crisis (e.g. Commission, 2006) went unheeded for a variety of reasons, but the absence of a shared methodology for measuring, inter alia, growth and inflation differences, credit booms and housing bubbles did not help matters. This methodology now exists in the form of the Macroeconomic Imbalance Procedure's scoreboard, which has the potential to develop into a clear and credible system of early warning against the drivers of future economic and financial crises.

As with debates about the Maastricht Treaty's convergence criteria two decades ago, the economic rationale behind the scoreboard is open to question. Particularly problematic in this regard is the excessive imbalance procedure's greater tolerance for current account surpluses compared to current account deficits, a politically convenient asymmetry given the reluctance of German authorities to countenance measures that could hinder the country's external competitiveness. That said, evidence that composite measures of macroeconomic imbalances could have provided an effective early warning for the eurozone in advance of the global financial crisis (Knedlik and Von Schweinitz, 2012) suggests that the excessive imbalance procedure is an economically worthwhile exercise.

Whether the Macroeconomic Imbalance Procedure is sufficient to correct for underlying macroeconomic imbalances is a different matter. For one thing, it seems unlikely that the financial penalties provided for under the six-pack will ever be levied against member states that persistently post excessive imbalances. A key stumbling block in this regard is that the complex transmission mechanism between government policy and, say, current account deficits or house price falls will make it difficult to establish conclusively whether a member state has taken corrective measures in response to earlier warnings. This leaves the Macroeconomic Imbalance Procedure dependent on peer pressure for enforcement, which in the past has suffered from serious shortcomings because of a reluctance by EU policy-makers to name and shame errant member states. It is too soon to pass judgement on the Macroeconomic Imbalance Procedure, but early experiences suggest that not much has changed in this regard. A case in point is the European Commission and ECOFIN's reluctance in 2012 to cite Cyprus for excessive imbalances even though the country exceeded a number of the indicative thresholds for macroeconomic imbalances (Commission, 2012).

References

Altavilla, C. (2004). Do EMU Members Share the Same Business Cycle? *Journal of Common Market Studies*, 42(5), 869-896.

Bank of England (2014) Financial Stability Report, Issue No. 35 (London: Bank of England'.

Bayoumi, T., and Eichengreen, B. (1997). Ever closer to heaven? An optimum-currency-area index for European countries. *European Economic Review*, 41(3), 761-770.

Claeys, P., Dreger, C., Moreno, R., Carrion, J.L. and Carme Riera, M. (2013) 'The European Dimension in the National Reform Programmes and the Stability and Convergence Programmes', Study for the European Parliament's Economic and Monetary Affairs Committee (Brussels: European Parliament).

Commission (2006) EU Economy Review (Luxembourg: Office for Official Publications of the European Communities).

Commission (2014) Recommendation for a Council Recommendation on the United Kingdom's 2014 national reform programme and delivering a Council opinion on the United Kingdom's 2014 convergence programme, Brussels, 2.6.2014 COM(2014) 429 final.

Dehousse, R. (Ed.). (2011). *The 'Community method': Obstinate or Obsolete* (Basingstoke: Palgrave Macmillan).

Heipertz, M., and Verdun, A. (2010). *Ruling Europe: The Politics of the Stability and Growth Pact*. Cambridge University Press.

Hodson, D. and Maher, I. (2001) 'The Open Method of Coordination as a New Mode of Governance: The Case of Soft Economic Policy Coordination' *Journal of Common Market Studies* Vol. 39, no. 4 (2001): 719-46.

Hodson, D. (2011). *Governing the Euro Area in Good Times and Bad*. Oxford University Press.

Hodson, D. (2015) 'Policy-Making under Economic and Monetary Union: Crisis, Change and Continuity' in H. Wallace, M. Pollack and A. Young (eds.) *Policy Making in the European Union*, 7th edition, (Oxford University Press, forthcoming).

Knedlik, T. and Von Schweinitz, G. (2012) 'Macroeconomic Imbalances as Indicators for Debt Crises in Europe' *Journal of Common Market Studies* Vol. 50, No. 5, pp. 726-745.

Linsenmann, I. (2003, April). Fiscal Policy Making under the Stability and Growth Pact, the SGP's impact on domestic institutions. In paper for the NYU-London/UACES conference, London (pp. 25-26).

Puetter, U. (2006). *European Policy Studies: Eurogroup: How a Secretive Circle of Finance Ministers Shape European Economic Governance*. Manchester University Press.

Tsoukalis, L. (2011). The JCMS Annual Review Lecture. The Shattering of Illusions–And What Next? *Journal of Common Market Studies*, 49(s1), 19-44.

Weyerstrass, K., Van Aarle, B., Kappler, M., and Seymen, A. (2011). Business cycle synchronisation with (in) the euro area: In search of a 'euro effect'. *Open Economies Review*, 22(3), 427-446.