# Chapter 5

# The fourth dimension: financial supervision and economic governance

Carlos Mulas-Granados

Since the early days of monetary union, the debate on the economic governance of Europe has always focused on the need for a better system of coordination between different member states. This discussion always revolved around the governance of monetary, fiscal and economic policies. The recent financial crisis has now added a fourth dimension to this discussion (financial supervision), and has changed attitudes towards further integration.

When the financial crisis started in 2007, the debate still struggled around the need to agree on a new institutional Treaty that could overcome the Dutch and French blockage to the Constitution. In this context, any discussion around economic governance referred to the economic barriers that the EU would face as a result of poorly functioning economic and fiscal coordination within a monetary union. Many of us agreed that this was provoking asymmetric fiscal deficits, interest rates that did not respond to the real economic situation and a negative divergence in unit labour costs. In addition, we all complained that economic reforms were not being applied, in all probability because the institutional design favored inaction and "a wait and see attitude", particularly if the measures to be taken were unpopular. As a result, the European economy was responding slowly and weakly to the challenges of globalisation and, therefore, was weakening the European project in the eyes of Europe's citizens.

In the spring of 2008, the European Commission tackled some of these issues in its report on 10 years of EMU,[1] but its prudent approach to reforming economic governance in the euro area, was quickly put under scrutiny by the need for stronger action in response to the threat of financial collapse. The events of October and November 2008 will therefore be seen as a turning point in this soft approach to economic governance. During this period, European leaders first acted in isolation but then had to concede to the need for a much stronger coordinated response, which ultimately soothed the financial panic that consumed Europe.

Since then, the debate on economic governance has increasingly departed from aspects of joint structural reform, and has focused on other important aspects such us the role of the European Central Bank, the need to harmonise banking regulation, the future introduction of a financial regulator, and most importantly, the need to reinforce coordinated responses led by the Eurogroup or the European Council itself. It is still early to extract conclusions, but it certainly seems that the financial crisis has managed to shift the existing debate on economic governance in Europe from issues related to coordination to those linked to further integration.

This chapter analyses the criticisms and the solutions put forward for economic governance in Europe over recent years, and offers a brief reflection on the slight advances that were introduced under the Lisbon agenda. It ends with personal reflections on what lessons we might learn from the current financial crisis, offering some proposals for the road ahead.

## Debating the governance of monetary policy

Of the three elements that compose the system of economic governance, monetary policy is the one which has received least criticism in recent years. The main objections that have been raised regarding the independent monetary policy of the ECB can be summarised into two points. On one hand, the ECB, by focusing exclusively on price stability, could heighten growth problems in the most important economies of Europe. On the other hand, it has acted "too independently" of Eurogroup finance ministers political viewpoints, and also from the opinions of markets regarding the value of the euro and its exchange rate. In addition, it has been unable to accommodate monetary policy with its fiscal stance, and to fulfill a role which makes structural reforms easier.[2]

Basically, the solutions that have been proposed aim in the direction of including growth and employment within the objectives of the EU (and perhaps within the statutes of the ECB), and maintaining price stability, similar to the Federal Reserve in the US. There have also been some proposals to modify the method of selection of the Executive Board of the ECB as a result of the growing nationalisation to which the bank is being subjected.[3] Some authors have also defended the possibility of establishing an institutionalised mechanism for dialogue between the economic ministers of the EU (that meet in the Ecofin) and the ECB, so that they can agree every three years on the ideal inflation objective for the euro zone.[4]

## Fiscal fortitude: creating good governance

This is the area where most scholars have expressed criticism in recent years. In some cases, the immediate implication of this criticism was that the monetary union would never work perfectly without a fiscal union. To fully understand these arguments, it is necessary to take a brief look at the original design of the fiscal policy pillar in the EMU.

The negotiations which led to the Maastricht Treaty were dominated by the alternative visions of France and Germany regarding the role that fiscal policy should play in the monetary union. While France defended the creation of an "economic government" that would ensure the "essential" coordination of fiscal policies within the EMU, Germany put its emphasis on maintaining price stability through strong mechanisms of fiscal discipline. In fact, both positions were included in the Delors Report (1989) that stressed both the need to determine in a coordinated manner the fiscal stance of the EMU, and the need to limit the size of budget deficits. Finally, both requirements became the base of the two pillars (the pillar of coordination and the pillar of fiscal discipline) of the Maastricht Treaty signed in December 1991.

Nevertheless, it is worth noting that the legal force of the pillar of fiscal coordination was much weaker than the legal force of the fiscal discipline pillar.[5] While article 104 of the Maastricht Treaty included a specific objective (the limit of 3%) and detailed a concrete procedure for sanctions for infringement (later reinforced by secondary legislature contained in the SGP), article 99 reduced the strength of the pillar of coordination by means of a general proposition.[6] Later, the creation of the Eurogroup in 1997 (only as an informal forum for discussion and under the Ecofin) to compensate for the signing of the strict and detailed Stability and Growth Pact, deepened the imbalance between the two pillars to an even greater extent.

The experience of economic governance and the euro since its creation has demonstrated that, paradoxically, the pillar of fiscal discipline has not worked as well as expected, while that of coordination has worked better than expected. In reality, the reform of the SGP in 2005 was inspired by this initial experience, but there are still many academics who continue to criticise the SGP as an instrument obsessed with fiscal discipline, but completely useless for fiscal coordination in good times or fiscal prudence in bad times.

Proposed solutions in this area take several different approaches. The most pro-European seem a poor fit with the current political situation in the EU, but they do aim to resolve various problems in one go. On the contrary, less ambitious solutions may enjoy greater acceptance, but they would need several simultaneous legislative modifications which would complicate their implementation.

The most obvious option to improve the functioning of the pillar of fiscal discipline would be to improve the reformed SGP of 2005 by incorporating positive incentives to comply with established limits, and strengthening the sanction mechanisms for infringement. To generate positive incentives, access to certain European funds (perhaps those related to the Lisbon Strategy) could be tied to compliance with fiscal discipline. In addition, a mechanism could be established in which fines are paid by those who don't comply with the SGP. In turn they can be used to finance a new specific fund destined for Lisbon policies in complying countries. This would eliminate the temptation for countries to collude in the Council (as we saw when France and Germany joined their powers to veto in the Council the Commission's proposal to punish them for excessive deficit in 2003). Finally, to improve sanction mechanisms all the proposals are geared towards giving the Commission a greater role in this area.

The most significant initiatives for resolving the problem of coordinating the fiscal policies of the different member states refer to the creation of a truly European fiscal policy designed and implemented by a supranational fiscal authority independent of member states, similar to the ECB in regards to monetary policy.[7]

It seems obvious now that the EU would have been much better off at the end of 2008 had it been equipped with a supranational European fiscal authority capable of bailing out the cross-border banks at the heart of Europe who went bankrupt. During 2009 we witnessed a strong asymmetrical form of economic crisis having a severe impact on eastern Europe, Ireland or Spain, while other countries like Germany or France suffer much less. The EU as a whole would have been much better off with a fiscal authority capable of redistributing funds and compensating for the deceleration of consumption and private investment by taking public action through a centralised fiscal impulse. Instead, Europeans had to limit their action to a coordinated small fiscal expansion approved by the European Council in December. This followed the Commission's proposal but left the composition of the expansion to each member state.

It is in this type of scenario (which was only theoretical until the present crisis) that the idea of pushing further towards a fiscal Europeanisation, which is capable of balancing full monetary union, became less utopian. However, today the situation stands as follows: on the one hand, the need to coordinate a European fiscal response to spend out of the recession has garnered support for the introduction of a new European fiscal authority or another form of economic government.[8] But on the other, the need to develop an economic government (maybe as the first step towards a political union) that will legitimise the actions of this European fiscal authority, and the subsequent Treaty modifications, prevent most from firmly defending this idea.

## Knock, knock, it's Mr./Mrs. Lisbon: realising effective reform

Since the launch of the Lisbon Strategy in 2000, the agenda for economic reform in Europe has run in parallel, and sometimes in contradiction, with agendas for social cohesion and sustainable development. In addition, the confusion generated by the proliferation of reform objectives and the weakness of the Open Method of Coordination (OMC) contributed to the revision of the Lisbon Strategy in 2005. At that time, the decision was made to reinforce the economic aspects of the Lisbon Strategy, since all agreed that the EU could guarantee the long term sustainability of its social and environmental model through growth and employment. In this strategy renovation the decision was also taken to group all the monitoring reports of the previous distinct agendas under one umbrella (the National Reform Programmes - NRP). This would be coordinated in member states through the creation of a new figure (a Mr. or Mrs. Lisbon) who would give public visibility to the process.

Since then, member states have named Lisbon coordinators and elaborated their NRPs annually. The Commission has then assessed the programmes – with a greater forcefulness each year. Without any doubt, the new process, since 2005, has improved the poor level of coordination which exists between the different reform agendas, but it has not managed to provide the highly visible strategy that was hoped for. In addition, the advances made in many areas continue to be limited.

Despite of the advancements, the risk that all the reform processes will again lack coordination is considerable for two reasons: from the Community point of view, responsibility for the areas of labour and microeconomic reforms (the core of the Lisbon Strategy) is in the hands of member states, and the Commission does not have sufficient instruments to lead them; and from the intergovernmental point of view, the actual overlap produced in many areas between the distinct formations within the council induces dispersion rather than aggregation.

To solve some of these weaknesses a series of minor technical measures have been devised, almost all to reinforce the role of the Commission in this process and to avoid the contradictions that are generated in the Council itself around its own role.[9] Based on the work of Murray[10] and Mulas-Granados,[11] and also incorporating other studies, the proposals can be placed into four groups:

- Finance ministers who meet in Ecofin should select their own president.

- Ecofin should be transformed into a "supercouncil" and should possess greater authority over all economic affairs than the General Affairs Council.

- The EU should integrate the Industry, Internal Markets, Energy and Telecommunications Councils into one Business Affairs Council, with the participation of the industry ministers of each country.

- And finally, the Commission should name its own Mr. or Ms. Lisbon from among its commissioners and he/she should be given the rank of vice president of the Commission. The whole process of National Reform Programmes should be improved with additional rankings that support naming-and-shaming.[12]

## Sharpening economic governance under the Lisbon Treaty

Having developed all the problems and proposals for improvement in previous sections, it is evident that an ambitious reform of the system of EU economic governance would have required a complete section in the Inter Governmental Conference launched in June 2007, a meeting that six months later led to the final agreement in Lisbon.

However, things did not work out that way. Given the need to save crucial aspects of the Constitution – such as the distribution of votes in the Council and seats in the Parliament, the division of responsibilities between the EU and member states, the presidency of the EU and the figure representative for foreign affairs – the fundamental questions of economic governance were postponed. Despite all of this, and although there were no modifications made regarding the governance of monetary policy, some improvements were introduced in the governing of fiscal policy and in the processes of economic reform which are worth pointing out.

Firstly, regarding fiscal policy, the modification which was introduced to reinforce the role of the Commission in applying the Stability and Growth Pact is important. To achieve this, article 104, section 6, was modified by substituting the word "recommendation" with the word "proposal". With this small modification, unanimity will be needed (everyone with the exception of the country to be sanctioned) to reject any proposed fine of the Commission. In this way, from now on when the Commission proposes (and not only recommends) fines in applying the procedures for excessive deficits, the probability of applying the sanction will be much higher and will avoid situations like the Franco-German veto of 2003.

Secondly, in matters relating to economic policy coordination, the new Treaty has included a modification of article 99 to reinforce the role of the Commission in this aspect.[13] In addition, coordination has been strengthened with the drafting of a new article 114, that among other things, confers on the Council the responsibility to "strengthen the coordination and surveillance of budgetary discipline," as well as "to formulate broad economic policy guidelines" for member states, assuring that they are compatible with those adopted by the rest of the Union. It also assures that they are effectively monitored.

Finally, another important advance has been the inclusion of measures which give legal standing to the Eurogroup as contained in two new articles (115 and 115bis). The goal here is to provide one voice for the euro in the world monetary system. It also recognises that the Council might designate (after a proposal from the Commission) “unified representation within financial institutions and conferences”. Or, in other words, there is a serious possibility that a Mr. or Mrs. Euro may be assigned responsibility for representing the single currency internationally.

## Reform after the financial crisis

More so than the issues relating to traditional aspects of economic, fiscal and monetary policies that have been discussed until now, the debate on economic governance has dramatically shifted focus during the last year as a result of the financial crisis.

The crisis has shown that the current system of governance may be more appropriate for good times – because it is stable, foreseeable, and has the necessary incentives – than for bad times.[14] In times of crisis, the current system lacks crucial properties such as speed of reaction, discretionary powers and centralised processes of decision-making in key areas of financial and fiscal policy.

For this reason we have seen a new area of discussion opening and developing around the need for a stronger more coordinated system of financial supervision, capable of preventing sudden cross-border systemic crises. In past months, many have defended the need to introduce a new European Financial Supervisor,[15] whereas others have pushed for a new role for the European Central Bank. While the introduction of a new financial authority will require a modification of existing treaties (with all the political difficulties that it implies), the activation of Article 105.6 in order to entrust the ECB with new tasks in supervision would not require a Treaty change, but would need unanimity in the Council of Ministers and assent by the European Parliament to come into force. However, entrusting the ECB with more powers has been opposed by many for two reasons: first, the UK would be left out of the core decision-making body of financial regulation when the City of London is the largest financial market in Europe; and second, investing more power in one institution in the absence of any political counterpart may exacerbate the existing institutional asymmetries.

In the midst of this debate, the De Larosière report released in February 2009 gave support to a third-way approach, proposing an overall reform based on two new institutional elements[16]:

- A new system of market-wide risk supervision. Setting up a “European Systemic Risk Council” (ESRC) to be chaired by the

European Central Bank president, and establishing an effective risk warning system under the auspices of the ESRC and the existing Economic and Financial Committee, which is made up of national treasury officials.

- A new day-to-day system of financial supervision. Creating a European System of Financial Supervisors and a decentralised network, with existing national supervisors continuing to carry out day to day supervision.[17]

The De Larosière report has been welcome by all parties in the debate because it finds a middle point between intergovernmental and communitarian proposals for financial framework reform in Europe. The probability that it will serve as the basis for coming reforms was further strengthened with the release of the Turner Review in March 2009, which indicated a change in the UK´s traditional opposition to any type of pan-European regulation in the financial sector.[18]

But again, any attempt to improve the existing governance structures (even in the field of financial supervision) will end up in confrontation with the need to solve the fiscal debate at the European level. It is obvious that the existing national jurisdictional domain of the fiscal authority provides significant problems for proposals to grant financial supervisory powers to any EU body (either the ECB or any new regulator). Macro-prudential supervision could be granted to a European body if it only had a limited advisory role, but in the current framework governments would be unwilling to cede national micro-prudential supervisory powers to an EU body whilst they hold the responsibility for bailing out financial institutions. If crisis management is to be at the European level rather than at the national level, there needs to be a federal source of money. Until the EU has fiscal powers which permit it to raise the funds needed to rescue distressed banks, or until there is a system of mandatory burden sharing between member states for fiscal support, supervision will remain the responsibility of member states. In this case, the real role of any new EU financial body will be very limited.

## Focusing on a future framework

Clearly, serious advances on the path to an improved system of economic governance were put off in the Lisbon Treaty. However, while this treaty was being ratified the financial crisis exposed all of its weaknesses. In turn, the crisis has added a new area of debate to the traditional discussion on governance of the single market and the single currency. Now we have a Treaty that not only ignores traditional debates about the imbalances between the governing structures of monetary, fiscal and economic policies, but also imposes strong limitations on the introduction of a new financial authority that might solve the problems which led us into the current systemic crisis – the complete absence of financial supervision and regulation at the European level.

Despite the reluctance to promote any initiative in the field of economic governance that implies Treaty modifications, the events of this past year have shown European leaders and public alike that individual responses to global crises are useless. The situation only began to stabilise in Europe after European leaders met in Paris in early October 2008 and decided to coordinate a common framework to solve the financial crisis. In my view this has definitively legitimised the political the role of the Euro group in times of distress, and has offered the first taste of what a European economic government might look like.

Even if this did not lead to breaking point, it at least served to change the tone of the previous debate, allowing us to reconsider some vetoed aspects of European integration. Whatever happens in the field of economic governance in the near future will depend on the political will of the leaders to push for major reforms, even at the expense of a new Treaty reform. Under both scenarios there are several options at hand:

***Minor reforms (no Treaty reform needed):***

- The Eurogroup should become the leading body for economic policy coordination in the euro area, even more so when sudden shocks require immediate and strongly coordinated fiscal policies.

- The Eurogroup should have single voice representation in the IMF and other international economic and financial institutions.

- The Ecofin Council should then be reoriented to the discussion of broader legislation affecting the Single market at EU27 level. It could incorporate some of the current Council formations, in order to focus on the competitiveness of Europe.

- A new European Fund for deep shocks in the Euro area could be established inline with future financial perspectives (similar to the current Globalisation Fund) to facilitate joint fiscal responses to systemic crises.

- A formal mechanism of permanent dialogue between the ECB and the Eurogroup could then be introduced, in order to better coordinate monetary and fiscal policy.

- The ECB could assume additional financial supervisory powers, under the current treaty provisions.

***Major reforms (Treaty reform needed):***

- A new harmonised regulation for the financial sector, which could require a stronger supervisory role for the ECB, or the introduction of a new European Financial Authority under a new European System of Financial Supervision.

- A new European Fiscal Authority (or a European Treasury) could be considered in the medium term. The European Fiscal Authority would have the capacity to bail-out major European banks, would lead the coordinated responses to systemic economic crises, and would play a complementary role to help national authorities during asymmetric shocks.

- A new EU Federal Budget. Increasing in size from its current level of 1% to 5% of EU GDP; it would be financed by pan-European corporate taxes and other sources of supranational financing (such as taxes on carbon emissions). The new federal budget would finance new supply-side transnational programmes (on R&D, education, energy, environment and infrastructures) that increase the EU's growth potential. This new budget would include new mechanisms to link financial perspectives, Lisbon reforms and compliance with SGP.

Over the past 50 years, all areas of European union and governance have been constructed in a step by step process. The case for a new system of economic governance will not be an exception. Yet, in reflection, it was not so long ago that, during the previous European recession of the early 90s, many questioned the very viability of the monetary union itself. But, here we are today in a situation were the euro has protected its members from major financial turmoil. Full economic integration will only come about in stages based on a joint political effort. Preventing future financial crises from happening should be an important motivation to push that joint effort forward in the years to come.