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UNDERSTANDING EUROPE – THE BIGGEST CHALLENGES OF THESE DAYS

Abstract

Europe is slowly starting to emerge from troubled waters, but five years of crisis have left a mark on the Continent. The growth remains sluggish, deflation remains a risk and unconventional monetary policy has had to be implemented. Faced with these facts, we may be tempted to feel disappointed with the European project. However, we should remember that we have come a long way since the start of the crisis. This paper aims to document the major reforms implemented on the financial services and economic governance fronts, as well as the observed austerity episode. It then goes on to consider three challenges going forwards, namely democratic legitimacy, the euro/non-euro divide and growth.

Keywords: European Union, EMU, growth, financial regulation, investment

Introduction

Over the last year, we have witnessed a number of momentous developments. Europe has returned to growth, although growth rates remain modest, following years of crisis. Unfortunately, many dark clouds still loom on the horizon. They include the lack of investment and slow and potentially faltering structural reforms. Moreover, over the past year, the European elections were held, dominated by an unprecedented wave of Eurosceptic sentiment. This has in turn cast doubts about the legitimacy of the European project.

To understand where we stand today and what challenges we will have to face, it is certainly worthwhile to look at how strikingly different the Union has become compared to its pre-crisis times. The first part of the paper will provide a brief overview

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of what has been achieved and where we stand today. It will in particular examine the reforms conducted both in the area of financial regulation and in the field of EU economic governance more generally.

The second part will look at current challenges. It will in particular focus on three issues: democratic legitimacy, the euro/non-euro divide and the investment crisis.

1. Responses to the Crisis: the 2009–2014 Reforms

We did not foresee the crisis and could not prevent it. However, we responded to the economic turmoil through a multi-fold approach, commensurate with the multidimensional nature of the crisis. The reforms triggered by the crisis are unprecedented and not too long ago, many of them were unthinkable.

The changes triggered by the crisis took place in two major areas: financial regulation and economic governance.

The first type of shortcomings that were addressed concerned the financial sector. When confronted with a financial crisis of large magnitude, which spread rather quickly within the European borders, it became evident that a framework for crisis prevention and management was sorely missing in the EU. A series of reforms were therefore initiated in order to fill the gaps and address the challenges revealed by the crisis, with the ultimate view of eliminating, to the greatest possible extent, the risk of financial crises happening again.

We have therefore, following the recommendations of the De Larosière (De Larosière 2009) report, reformed the architecture for macro- and microprudential supervision in the Union. On the macroprudential side, a European Systemic Risk Board was established in 2010 and tasked with overseeing the EU's financial system and tackling systemic risk (Regulation 1092/2010, 2010). At the same time, on the micro-prudential side, weak supervisory Committees were replaced by three supervisory authorities with greater power (Regulations 1093/2010, 1094/2010 and 1095/2010, 2010).

We have also begun regulating a number of specific areas. To mention only the main examples, we started to regulate hedge funds (Alternative Investment Fund Managers Directive, 2011/61/EC, 2011) and credit derivatives (European Market Infrastructure Regulation, 648/2012, 2012), as well as amended the regulatory framework for insurance undertakings (Solvency II Directive, 2009/138/EC, 2009).

Later on and more fundamentally, we built the foundations of the European Banking Union. We elaborated on a single rulebook for European credit institutions, carefully watching over solvency and liquidity concerns. A Single Supervisory Mechanism (SSM) started to operate in November 2014. A Single Resolution Mechanism (SRM) is gradually being constructed, with a Single Resolution Board, whose members were appointed in December 2014, and a Single Resolution Fund to be progressively implemented.

This is an impressive result, which shows that we have come a long way. Nevertheless, some challenges still lie ahead of us, mostly related to the regulation of the shadow banking sector and to the measures to be taken to promote investment and growth in the EU.

The crisis has revealed more deep-rooted flaws in the design of the Economic and Monetary Union (EMU). The experience of the crisis revealed that the architecture of the EMU was not only incomplete, but also laxly implemented. This situation called for radical reforms of the economic governance of the Union, which were undertaken with a primary focus on the euro zone.

The pre-crisis EMU design was based on the 1992 Maastricht Treaty and on the Stability and Growth Pact (SGP), which consisted of two Council regulations adopted in 1997 (Regulation 1466/1997 and 1467/1997). The SGP aimed to provide a rule-based framework for the coordination of national fiscal policies in the EMU by requiring budgetary positions to be "close to balance or in surplus", as well as by establishing an Excessive Deficit Procedure (EDP), which would be triggered once a Member State reached a deficit-to-GDP ratio higher than 3%.

However, after the creation of a single currency in 1999, the SGP proved to be insufficient.

The main problems are posed by the difficulties in the enforceability of the SGP, and consequently its limited credibility. This became evident when, in 2003, France and Germany blocked the procedure which would have brought them closer to the imposition of the sanctions under the EDP. This episode demonstrated that it was possible for Member States in breach of their obligations to escape the sanctions incurred under the SGP. After this episode, the Pact was also amended and several of its provisions relaxed, thereby further weakening its firepower.

Moreover, managing macroeconomic imbalances was outside the remit of the SGP.

As a result, the Pact failed to keep in place sound public finances and could not address the growing divergences in competitiveness between Northern and Southern Europe.

The path to reform was far from smooth as opinions differed widely on the direction that the reforms should and would take. The scope of the measures adopted and the extent to which they would interfere with issues of national sovereignty were of particular concern, bringing into the spotlight the difficult issues of democratic legitimacy.

In 2011, in line with the SGP principles, the policymakers launched the European Semester process, a six-month economic policy coordination cycle between national governments and national authorities, lasting from January to July each year. Under that process, national governments are obliged to submit their Stability and Convergence Programmes to the EU authorities prior to discussion by national Parliaments. A series of discussions between the Member States and the European level follow, whereby national governments declare the economic policy actions they plan to undertake, and then receive country-specific recommendations from the Commission. The advice received plays an important part in the drafting of national budgets.

Also building on the SGP, the six-pack (2011), consisting of five regulations (Regulations 1173/2011, 1174/2011, 1175/2011, 1176/2011 and 1177/2011) and a Directive (Directive 2011/85/EU) adopted in 2011, further strengthened the SGP in a number of ways. It reinforced the excessive deficit procedure by making it applicable when the debt limit is exceeded, quantitatively defined what constitutes a "significant deviation" from the medium-term objective or from the adjustment path towards it, made the imposing of sanctions more automatic and introduced a procedure to detect and address macroeconomic imbalances.

The Treaty on Stability, Coordination and Governance in the Monetary Union (known as the TSCG or the "fiscal compact") (2012), signed in 2012, reinforced the six-pack, demanding that contractual parties stuck to their convergence towards the country-specific medium-term objectives, as defined in the SGP.

Policymakers also introduced the two-pack (2013), a duo of regulations (Regulation 472/2013 and 473/2013) targeted at the euro zone only, which dealt with strengthening budgetary surveillance in good economic times and included specific provisions for countries faced with economic difficulties.

On the occasion of the December 2014 Ecofin Council, the European Commission presented a Communication (European Commission 2014) assessing the reforms undertaken in the area of EU economic governance and the subsequent discussions hinted at the willingness of EU ministers to drive further the integration of the EMU. In February 2015, an analytical note was issued by the presidents of the Commission, the European Council, the ECB and the Eurogroup (Juncker, Tusk, Dijsselbloem and Draghi 2015), in which the presidents made a list of crucial questions to be addressed in the debate on the future of the economic governance, concerning issues such as whether the current economic and fiscal governance framework is adequate and how to improve its effectiveness; whether we have really managed to break the negative bank-sovereign feedback loop; how to improve private risk-sharing through financial market; whether risk-sharing in the fiscal realm is desirable and on what conditions; whether common institutions are needed and how to improve democratic legitimacy. This is to be followed by a report from the presidents which will be published in June 2015 and outline a vision for the future of the EMU, answering the questions raised in the analytical note.

All of this reminds us that we will not be facing easy times ahead and that debates on the economic governance of the European Union are likely to continue for quite some time.

Therefore, what are the main challenges for the future?

Three issues are prominent: the democratic legitimacy, the retention of a united Europe in the light of pronounced euro/non-euro divisions and the question of restoring growth.

2. Democratic Legitimacy and Institutional Balance

The democratic legitimacy of European integration has been growing to be a challenge for quite some time. In recent years, it has acquired a new dimension in the context of the reforms of the euro zone governance, which have raised the issue of democratic legitimacy of European decision making on an unprecedented scale.

Substantial changes have taken place over the recent years. However, the reforms undertaken have not been based on and driven by a long term vision, but have taken place incrementally, following a step-by-step approach.

This is somewhat traditional in the EU, where, throughout history, a teleological approach to reform has usually been rejected. However, maybe paradoxically, the method based on gradual change fails to generate confidence and enthusiasm among citizens, as they do not clearly see the direction and the purpose of the reforms.

This is why, today, at this crucial time, we need a vision for Europe.

We have also witnessed a de facto institutional evolution, based on concrete changes and faits accomplis and unaccompanied by formal legal changes.

The European checks and balances have been shaken up over the recent years.

We can see that some European institutions have gained new competences. Typically, since the Treaties were rather vague on some of the institutions, the new institutional territories of entities such as the Eurogroup or the European Council have become a new reality through action.

The European level has also made a real move towards increased control of a greater number of components of national economic policies. With the reforms of the European economic governance, countries have become more accountable to the Union regarding their economic and fiscal policies.

This has created an additional legitimacy challenge – the need for double legitimacy, involving both European and national parliaments.

We also notice that, paradoxically, while reforms have gone in the direction of increasing centralisation, the European integration has shifted its weight towards the method of integration previously called intergovernmentalism, as relatively often, the Member States resorted to intergovernmental agreements instead of procedures based on the community method.

This phenomenon can be explained by many factors. Among others, the insufficiency of the legal bases available for some of the reforms, the need for unanimity for the Treaty changes and internal pressures in some Member States, but alarming events in the surrounding world, which called for European solutions in the areas within national competences, are worth mentioning as well.

As a result of all this, the relation between the European Union and its citizens has become a challenge to urgently cope with, comprising issues such as transparency, inequalities, fairness, participation and general democratic legitimacy of the process and the content of European decision making.

3. The Euro/Non-Euro Division

For obvious reasons, the focus of economic governance reforms has been on the euro zone. The political challenge was, firstly and most urgently, to create a fully-fledged smoothly functioning area with a common currency. However, as reforms continue and the euro zone integration deepens, an equally important challenge is to keep the European Union united.

Recent reforms paint a picture of a two-tiered Europe, composed of a strong (extended) euro zone core and of a group of "outs".

While a number of reforms, such as the two-pack or the European Stability Mechanism (ESM) treaty, have been focused solely on the euro zone, several of the remaining reforms are open to Member States which eventually wish to adopt the common currency. This is the case with the six-pack, the TSCG and the SSM with its opt-in clause.

There is certainly a tendency to take on board the non-euro zone members in the current reforms aimed at strengthening the EMU. However, suggestions contrary to this tendency are sometimes made, for instance in the 2012 Commission communication

(European Commission 2012) which proposed to create a eurozone budget, a eurozone committee in the Parliament and a single eurozone seat in the IMF.

Policymakers will need to slowly take a stance on whether the pre-ins should be properly involved in recent policies and, if this is the stance they want to take, they should strive to make the core as inclusive as possible. The question of how to achieve the objective of a more united core is also tricky. One option would be to make more use of the enhanced cooperation provision of the treaty.

Even if the "extended" core we bring about is as inclusive as possible, the ensuing two-tiered structure of Europe will still bring along a number of risks. They include a more fragmented single market and a potentially weaker standing of Europe on the global policy scene.

4. Sluggish Growth and the Investment Gap

After the downturn witnessed in 2009, the steady growth did not return and, as a consequence of this economic stagnation, unemployment rates, soaring in the wake of the financial crisis, are still very well above their pre-crisis levels.

For years now, both public and private investment have been in decline in Europe. This ever-growing investment gap is compounded by the lack of innovation, which resulted in productivity slowdown. Insufficient innovation and investment hold back our economies and result in sluggish growth and low job creation (Phelps 2015). To mention only one indicator in this respect, the 2014 Innovation Union scoreboard (European Commission 2014) revealed once again that in terms of innovation, Europe lags behind not only US and Japan, but also South Korea (Nixon 2015). In this context, it has become clear that complementary measures would be needed in order to kick-start growth, unleash investment and enhance competitiveness.

The EU took initiative to address these issues. The European Fund for Strategic Investments (EFSI) announced at the end of November 2014 and made concrete in a Commission proposal in January 2015 (European Commission 2015a) promises to be pivotal in this regard by mobilising up to 315 bilion EUR worth of investment. The idea is to encourage private sector investment through an EU guarantee given to the European Investment Bank. This fund is aimed at supporting projects in the field of infrastructure, education, energy and environment, and SME financing. In order to assist in the "identification, preparation and development" of such projects, a European Investment Advisory Hub would be established. The European Investment Fund would also be accompanied with a transparent project pipeline.

This initiative is most welcome in the current context. However, for it to be a success, we must make sure that we get the regulatory aspect right. This means regulating smartly and optimally, so as not to suffocate willing private sector actors.

Parallel to the EFSI, in February 2015, the Commission launched (with a Green Paper) the Capital Markets Union (CMU) project (European Commission 2015b). This initiative aims to create a true single market for capital and to diversify the financial system by complementing the European banking system with sound capital markets. The CMU should focus, in particular, on helping SMEs access funding more easily. Consultations with stakeholders on the CMU started in February 2015 and lasted until May.

The road towards CMU is paved with challenges, which will need to be addressed. The integration of EU capital markets is still hindered by economic and legal obstacles. The single market still faces a fragmentation in terms of depth of capital markets in different countries. Moreover, the EU as a whole still lags behind other areas of the world, such as the US, when it comes to stock market, equity markets and venture capital market development.

The CMU raises difficult questions, namely concerning whether it is feasible and even desirable to change the traditionally bank-based European finance and economy; what kind of capital markets Europe can expect to develop; and whether we have introduced a regulation which might actually impede the good functioning of capital markets. For instance, bank capital requirements introduced in order to ensure that our credit institutions remain sound and solvent might interfere with the institutions' ability to support capital markets. These are the questions which we will need to answer over the coming years.

Conclusions and Recommendations

We have certainly come a long way concerning the economic governance framework since the start of the crisis. However, we need further reforms to improve and complete the governance of the euro zone. There seems to be a growing consensus that the weaknesses of the common currency system could be corrected by a deeper fiscal integration. In carrying out the additional reforms needed, we would not be starting from scratch, but would have laid the foundations on which we could build further fiscal integration.

Further progress would require more effective control of national budgets, which might imply a stronger role of national parliaments in European governance. It would require some form of European fiscal capacity to improve the extent to which economic shocks can be absorbed. Better fiscal coordination would also help shifting the burden of coping with future crises to ex ante rather than ex post instruments.

The reforms mentioned above would however not be effective without a mechanism to coordinate structural policies and implement structural reforms. Nevertheless, purely cooperative approaches to fostering structural change have shown its limits over the last decade. For structural reforms, both commitment technology and enforcement capabilities remain a challenge.

A genuine fiscal union, which is desirable, should rest on a few cornerstones. These include strong oversight and incentives for sound national fiscal policies, instruments enhancing fiscal risk sharing (which bring with them new risks), as well as a genuine break between sovereigns and the banking sector, probably going beyond the mechanisms we have in the banking union.

The current situation also raises the question of how far and how long we can continue to stretch the current treaties and use them as the legal bases for further reforms of economic governance. A new treaty might be necessary at some point, even though the political risks entailed are high and we might need to think of a new procedure for its ratification and entry into force.

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