BALANCE OF COMPETENCES ON ECONOMIC AND MONETARY POLICY

A response to the call for evidence

Stephen Pickford and Paola Subacchi
International Economics, Chatham House

The UK as a member of the EU has strong interests in the economic governance arrangements in Europe, both directly and indirectly. Its direct interest is in the economic policy structures that the UK is fully engaged in, in particular the single market. Its main indirect interest is in the governance and operation of the single currency area, which is the UK's biggest single trading and economic partner.

Economic governance of the euro

One of the biggest economic risks facing the UK at present is the threat of further financial and economic stability within the euro area (EA), given the depth of economic integration between the UK and the EA. The EA is the UK's biggest single trading partner[1], and the financial ties between the UK and the EA are very strong. For example, over one-third of the UK's portfolio investment assets and liabilities are with euro zone countries[2]; the EA accounts for 30 percent of UK banks' international lending[3]; and the UK's financial services sector has a dominant share of many European financial markets[4]

And one of the biggest potential sources of instability in the EA arises from shortcomings in its system of economic governance of the single currency and associated economic policies. The economic and financial crisis exposed serious shortcomings in the design of the euro, and of EMU more generally[5]. As the crisis grew in the EA in 2011 and 2012, this also affected the UK as interest rate spreads widened, exchange rates adjusted, and growth prospects worsened

The EA falls well short of the requirements for an optimal currency area, in particular because of the lack of convergence between its members. And the governance structures supporting EMU do not provide effective mechanisms to achieve proper convergence, or to compensate for lack of convergence. These shortcomings led to serious concerns that the single currency would disintegrate. Even though those concerns have abated since 2012, the problems that led to the crisis still in large part remain.

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[1] EA members accounted for 40% of UK total exports and 45% of its imports in 2013: Source: ONS
[2] Source: IMF
[3] Source: BIS
[4] For example, the UK accounts for over one-half of EU activity in interest rate OTC derivatives trading, forex trading, hedge fund assets, private equity funds raised, marine insurance premiums, and fund management. Source: TheCityUK
[5] See recent Chatham House reports: "How to fix the euro" http://www.chathamhouse.org/publications/papers/view/198575; and "Broken forever? Addressing Europe's multiple crises" http://www.chathamhouse.org/publications/papers/view/182647

Through the decade leading up to the crisis, divergences in competitiveness between the EA members increased substantially. This was an important factor explaining why the global crisis affected the EA so badly. In the absence of exchange rate flexibility, EA members need greater flexibility (of factors of production and finance) and incentives to adjust. Also the single currency structures place insufficient responsibility on surplus countries within the EA to contribute to reducing imbalances. And there needs to be better coordination across different arms of economic policy within the EA.

This requirement was recognised from the outset of discussions on EMU in the Werner and Delors reports. As the consultation document correctly notes:

> "*Looking back at the period from 1999 to 2007, it is clear that wider economic policies were insufficiently coordinated to prevent the build-up of serious macroeconomic imbalances within the currency area*" (para 2.20)

Some progress has been made on a number of these issues in recent years, in response to the crisis in the euro zone. In particular, the governance of fiscal policy has been strengthened, and the first moves made towards banking union, through the creation of a single supervisor. But we argue that to achieve greater integration of policies, the EA needs to move towards a single fiscal authority, an effective mechanism to resolve failing financial institutions, better incentives for economic policy reforms, more effective coordination of the single monetary policy with wider economic policies, and an effective lender of last resort for EA members. These will require more fundamental reforms to the governance of the EA.

Many of these governance issues do not directly concern the UK, because of its opt out and because the Government has stated that it has no intention of seeking to join the euro. Indeed the UK has explicitly opted out of many of the structures that have been recently introduced. But some of the issues do directly impact on the UK, especially where they interact with the single market. The most obvious example is banking union, because of the potential effects on the single market for financial services, where the UK's financial sector plays a dominant role. Also, the indirect impact on the UK if further EA crises materialise are potentially enormous.

In our view it is in the UK's strong self-interest to play a constructive role in assisting the EA to strengthen its system of governance, which will necessarily involve greater economic, financial and political integration between the EA member states. At the very least the UK should recognise that it is in its own interest to allow further integration to take place in the euro zone, and it should avoid taking positions which will hamper that process.

Economic governance within the broader EU

Aside from the single currency itself, and the associated structures for economic coordination within the euro zone, the UK has a number of economic governance responsibilities which apply to all members of the EU (whether inside or outside the EA). These cover: fiscal policy, broader economic policies (including structural policies), and financial policies.

Under the principle of subsidiarity, the responsibilities between member states and European institutions (both EU-wide and for the EA) are – and are bound to be – intertwined, both in law and in practice. But this leads to differences of interpretation and arguments over the respective roles of national and European policy-makers and legislators. Finding ways to give greater clarity to the balance of responsibilities and to encourage better coordination between policy-making at the national and European levels, is a key challenge.

But perhaps more importantly, the dividing line between on the one hand issues of concern to EMU and the operation of the single currency, and on the other hand matters involving all EU member states and the single market, is grey and fuzzy. Banking union is an important case in point. The new institutions, mechanisms and processes that have been created in recent years have added to that lack of clarity.

Future governance arrangements between euro 'ins' and 'outs'

This lack of clarity has raised fundamental issues of competence between the institutions (and the members) of the single currency, and the wider EU. The UK in particular has started to resort to legal challenges in a bid to establish greater clarity.

As coordination between EA member states deepens, and they move further towards a 'genuine' economic and monetary union, this will necessarily throw a greater spotlight on the contrast between increasingly close policy coordination within the EA, and looser links with non-members.

Some institutions and mechanisms (eg most of the provisions in the Six-pack, the Two-pack and the European Semester) are clearly restricted to EA members only, while some have to involve all EU members. But there is now a large, and growing, list of bodies and processes which require EA member involvement but also allow non-EA members to participate. Given the possibility for all EU members to join EMU (and the requirement for all but the UK and Denmark eventually to do so), this is unavoidable. But the existence of institutions with universal reach across the EU – the Commission and the Parliament in particular – means that greater clarity over the multi-dimensional variable geometry of Europe is essential.

If the EU is to succeed in meeting the aspirations of both 'ins' and 'outs', it will have to find ways to define more precisely what decisions should be taken at formations of the 18 EMU members, of the 28 EU members, or of some number in between. The explicit definition of the rights and responsibilities of 'ins' and 'outs' in the voting structures for decisions of the European Banking Authority (EBA) suggest that this is not an impossible task. But it does require political will to achieve.

Questions 1-3 and 7: *The balance of competences and roles between the Council, the Commission, the European Parliament, and national Parliaments, and economic policy coordination*

The first set of questions concerns the balance between the responsibilities of national governments, national parliaments and inter-governmental bodies (especially the Council) on the one hand, and the roles of supra-national executive and legislative bodies (especially the Commission, ECB and EP) on the other.

In some ways the relationship between the Council of Ministers (representing the governments of all EU members) and the Commission (as the executive agency for the EU as a whole) mirrors the relationship between national parliaments and the European Parliament. These relationships go to the heart of the EU and the debates on sovereignty and subsidiarity.

Fundamentally, the decision on the limits of coordination and the sharing of responsibilities within the EU is a political one.

But there is also an important economic question about the benefits and costs of economic cooperation. A joint project[6] between Chatham House and the IMF is looking at the experience of the 2008 economic crisis which saw a huge boost to international economic cooperation. This work suggests that:

- the costs of not cooperating can be very substantial if trust is lost between governments. This is a more important driver of cooperation than seeking small gains from cooperation to deliver more optimal policies.
- when economies face extreme circumstances – for example, when interest rates are close to zero or bank lending is constrained by insufficient capital – potential spillovers to other countries are amplified and the gains from international cooperation are substantial.
- a significant barrier to cooperation is when countries fail to agree on the size (or even the direction) of policy spillovers, for example on the effects of unconventional monetary policies.
- the institutional arrangements for cooperation are important in determining its effectiveness.

In the European context this has a number of consequences.

First, decades of discussion between member states on economic policy issues, while stopping short of 'coordination' (as commonly defined in the economic literature), has significantly reduced the possibility of a substantial breakdown of trust such as led to 'beggar-thy-neighbour' policies of the 1930s. The exclusive competence of the EU over trade issues and the deepening of the single market has made a conventional trade war within the EU near-impossible.

[6] Bayoumi and Pickford, "Is international economic policy cooperation dead?" http://www.chathamhouse.org/publication/international-economic-policy-cooperation-dead

However, the experience in recent years has shown that big trade imbalances can emerge within the EU and (more importantly) within the euro zone. Instead of manifesting itself in a trade war, these pressures led to big disagreements about the degree of fiscal austerity, the conditions for financial support and the governance arrangements within the euro zone. The UK, with a freely floating currency, was more insulated from these pressures than other euro 'outs' which tie their currencies much more closely to the euro. But the tensions within the EA have forced its members to increase the degree of policy coordination.

Second, the extreme circumstances of near-zero interest rates and credit constraints added significantly to the crisis in Europe. The 'sudden stop' of capital flows to the EU periphery imposed very heavy costs on countries such as new EU members whose financial sectors were dominated by banks from other member states. This contributed to the willingness of countries to consider more radical modes of cooperation, including moves towards banking union and the establishment of the ESM as a substantial firewall.

Third, there are significant spillovers within the EU, but especially within the euro zone given the operation of the single currency. However, the Council has proved a fairly ineffective mechanism for reaching agreement on the size (and sometimes the direction) of these spillovers. The debate about intra-EU balance of payments surpluses and deficits is a case in point, with Germany (by far the largest surplus country) refusing for a long time to accept that this represented a problem for Europe.

The new surveillance arrangements (in particular the MIP) can be seen as an attempt to force countries to reach more agreement on the size of spillover effects, by giving more power to the Commission to express its view on national policy settings and to enforce changes through the EDP and EIP (with stronger sanctions and less leeway for countries to avoid Council conclusions).

It is appropriate, given the stronger spillovers within the EA, that these arrangements have more force within the EA than across the entire EU. However, this system still has two shortcomings: the disciplines apply more rigorously to fiscal imbalances than to broader macroeconomic imbalances; and it remains to be seen whether member states have the political will to force national governments to change course. The experience of the crisis suggests that macroeconomic imbalances were more important than fiscal imbalances; and the track record of the SGP does not suggest that the Council will be an effective source of discipline on national governments. So there may be a case for even stronger powers for the Commission in the future, to deliver greater convergence and cooperation over macroeconomic policies within the euro zone. Of course, if the EA moves eventually towards a single treasury function, this agency would acquire greater powers over policies which are currently the preserve of national governments.

As to the position of the EP, this again is fundamentally a political question. But if powersshifted over time from member states to the Commission (especially over EA policies), this would argue for greater oversight of the Commission's overall activities by the EP, to provide a degree of democratic accountability. But if, for example, the Commission were to recommend country-specific policy changes, or policies which impacted particularly on specific member states, it is very hard to see that the relevant national parliaments will not also be involved also in overseeing the Commission's decisions. This would potentially set up a tension between national parliaments and the EP, and in the event of disagreements it is not clear which could (or should) dominate.

<u>Questions 4-6 and 8: *Relations between euro area 'ins' and 'outs'*</u>

The second set of questions relates to the relationship between the members and institutions of the eurozone (which have been considerably strengthened by the reforms of the last few years) and other member states which have not yet qualified for EMU membership or have an opt-out, but which have the full rights and obligations of EU membership.

As noted earlier, this is a key but difficult issue. Over time the degree of coordination over economic policies within the EA has increased significantly, not least in response to the crisis. This is appropriate, given the high level of interdependencies and spillovers between the EA members. But the economic links between the 'ins' and 'outs' have also increased over time, so that the 'outs' also have a strong interest in the economic success of the EA.

The scope of EA decision-making processes has extended over time into areas where all EU members have an interest. This was always the case, not least because the single monetary policy has implications for the euro's exchange rate against all other currencies (including those of the 'outs'). But as the reach of policy coordination within Europe has grown, EA processes have had a more direct impact on countries which are not members of the euro zone. In some cases this is a matter of degree – for example, all EU members are involved in the SGP and the MIP, but the sanctions for running excessive fiscal deficits or excessive imbalances are much tougher for EA members. In other cases, 'outs' are not part of the process at all – in some instances because they have chosen not to be involved, such as the UK's non-participation in the SRM.

The consultation document notes the *de jure* position that the Eurogroup is "a non-legislative body that can only discuss matters related to the single currency". In practice, however, the interlinked nature of economic policy-making and the fuzzy boundary between the responsibilities at the EU and EA level mean that the Eurogroup can take common positions on matters, even if formally they are a decision for the ECOFIN. And since the EA forms such a significant voting bloc in

QMV terms, it is virtually certain[7] that on issues where there is a consensus in the Eurogroup, this position will be ratified by the ECOFIN under QMV.

This has been most obvious in the area of financial services reform, where the EA has decided to press ahead with changes to regulation, supervision and resolution mechanisms for failing institutions, as part of the move towards banking union. But the single market in financial services is an EU-wide construct. The UK (which has the most important financial services sector in the EU) has challenged some of the decisions of the Commission on aspects of financial services legislation (eg the financial transactions tax). The UK has also secured greater involvement for 'outs' in the decisions of the EBA, and stronger protection for their interests, through double-majority voting provisions.

But as the integration of the EA proceeds over time, the UK (and other 'outs') will face a potential conflict of interests. Given the fuzzy boundary, there will be cases of EU-wide concern where the Eurogroup may be perceived as overstepping its responsibilities. The UK (and other 'outs') will then have to decide whether to challenge the Eurogroup.

We would argue that where this happens the 'outs' should adopt a case-by-case approach. On the one hand Eurogroup decisions could adversely affect the interests of the 'outs' on that specific issue. But to the extent that the EA would perform better or its financial stability enhanced, this would be in the interests of the 'outs' also. In each case the 'outs' would need to reach a view as to whether their interests are on balance harmed or improved. And the 'outs' would substantially improve their chances of winning any battles with the EA if they acted together.

<u>Questions 9-14: *Operations of the European Semester, the Macroeconomic Imbalances Procedure, the Stability and Growth Pact, and financial assistance mechanisms*</u>

There have been many reforms to economic governance since the crisis, covering all aspects of economic policy. The third group of questions concern how well these have been designed and how efficiently they operate.

Most of the reform effort has been concentrated on structures for the surveillance of fiscal policy, reflecting the widespread assessment[8] initially that the crisis in Europe was largely the result of profligate national fiscal policies. As a consequence, both the 'preventive arm' of the SGP and the 'corrective arm' (the EDP) have been tightened. The timing of national budgetary process has also been defined through the European Semester, in order to standardize national timetables and allow the

[7] When voting proportions change later this year, the EA members will together form a qualified majority.
[8] This view was particularly strongly held by many of the 'core' countries in the EA, and was reflected in the design of the conditions attached to financial assistance programmes for Greece and Portugal in particular.

Commission to request revisions to draft national budgets. The strongest sanctions and toughest conditions have been confined to the EA members, and many of the provisions do not apply to the UK.

But despite the breadth of the fiscal policy reforms, it is far from clear that they have had a marked impact yet on fiscal outcomes. For example, the reports on draft budgets for 2014 found that the budgets of five countries (Spain, Italy, Malta, Luxembourg and Finland) were at risk of failing to comply with the SGP. It is perhaps too early to see the full effect yet, but to date these strengthened provisions have neither prevented nor corrected excessive deficits. Instead, most of the pressure on countries to reduce fiscal deficits has been a result of the terms attached to financial assistance programmes (jointly administered by the Commission, the ECB and the IMF).

Also, the history of the SGP does not provide an optimistic precedent. Political expediency has always in the past tended to dilute decisions. Greece and Italy were allowed to join the single currency despite having public debts well in excess of the 60% ceiling. And in the early 2000s both France and Germany avoided being fined for breaches of their SGP targets.

The MIP has also not got off to a good start. Early decisions about the triggers for Commission action on imbalances seemed to have been designed to ensure that Germany's balance of payments surplus would not be considered 'excessive'. But it is encouraging that there is now a mechanism in place to address wider macroeconomic imbalances (which were an important contributory factor behind the euro area crisis). It should also act as a counterweight to the fiscal provisions of the SGP, which was given too much prominence in early discussions of the response to the crisis.

If used well, the MIP has the potential to markedly improve economic coordination within Europe. We argue therefore that it is in the UK's own interest to play an active and leading role in the MIP process, even though the sanctions do not apply with full force to the UK.

By contrast the EU's attempts at coordination of structural policies have not been successful. The Lisbon Process and the Europe 2020 strategy set in place detailed processes to prioritise structural reforms and encourage countries to implement them. Improving flexibility of labour and product markets is important, both for the operation of the single currency and for growth in Europe more generally. But these processes have achieved little, in large part because the actions to be taken are country-specific, and have to be implemented by national governments. They are also politically contentious, and European coordination of these efforts has not been productive. The contractual approach favoured by the Commission may be more successful because it provides positive incentives for countries to act, but experience suggests that it will be a very long and uncertain process to put these structures in place, and then for them to lead to substantial structural reforms. This makes it even more necessary that other governance reforms are put in place for the EA to compensate for the absence of reforms to make countries more flexible.

Concluding comments

The issues raised by this consultation go to the heart of the EU as a mechanism for coordinating economic policy between its members. But they also expose all the political issues raised by membership of a supra-national bloc.

The political issues will have to be debated and decided upon elsewhere. But the economic case for and against cooperation, and whether the form of cooperation currently in place in Europe (both within the EU and the EA) is optimal, deserves to play its part in that debate.

This consultation is also aiming at a moving target. Coordination, and the processes to achieve it, is evolving quickly. We have argued that in order for the single currency to survive and to serve as an instrument for stability and prosperity (rather than as a source of instability), economic and policy integration within the EA needs to deepen. And since a stronger and more prosperous euro zone is in the UK's economic interests, the UK should assist that process of integration.

Measures to increase coordination across the EU as a whole can also be in the UK's interests. The spillovers from national policy actions for the EU as a whole are not as great as within the EA. But the broader (and less rigid) processes for policy cooperation across the full range of economic policies through the MIP deserve to be given a chance to succeed, in order to avoid the chronic imbalances which exacerbated the crisis in Europe.