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EU's Competences in the Area of Economic and Monetary Policy – a Critical Review

1. Introductory remarks

1. This brief note has been written in response to the HM Treasury's Call for Evidence within the UK Government's Balance of Competences Review to examine the balance of competences between the UK and the European Union. The opinions presented here represent solely the view of their author and not necessarily the institutions which he is affiliated with. Thus these opinions can be attributed publicly to the author only.
2. The author of this note is not willing to enter the debate on the advantages and disadvantages of the UK's membership in the EU and what kind of policies and institutional solutions best serve UK interests. Rather the views presented here try to assess rationale of the existing stock of EU's primary and secondary legislation, governance practices and new draft legislation currently discussed from the point of view of the entire Union as a deeply integrated economic area. Consequently, the questions 5-6 and 13 will not be answered in this note.
3. Taking into consideration author's background (international macroeconomics) the comments presented in this note will concentrate on economic content and mechanisms of various pieces of actual and potential future EU legislation rather than their legal aspects.
4. The content of this note will be divided into following sections: Stability and Growth Pact (Section 2), Financial Assistance Mechanisms (Section 3), Macroeconomic Imbalances Procedure (Section 4), mechanisms of 'soft' coordination of economic policies such as Europe 2020 Strategy or European Semester mechanisms (Section 5), banking union (Section 6), and future evolution of the Economic and Monetary Union (EMU) (Section 7).

2. Stability and Growth Pact

5. Fiscal stability of EU member states whether members of the Euro Area or not should be considered as an important European public good preventing the entire EU and its common market from cross-country contagion and negative impact of excessive fiscal imbalances on financial sector and financial markets. That means the idea that the mechanism of fiscal discipline should be regulated by the Treaty and EU secondary legislation is, in principle, right.
6. The numeric targets set in the Treaty of Maastricht in early 1990s (the deficit not exceeding 3% of GDP and public debt not exceeding 60% of GDP) reflected the macroeconomic realities of that period when the average level of public debt within

the EU12 was lower and average growth rate higher[1] as compared to the post-financial crisis situation of early 2010s. In the context of the current low growth rates and gross public debt approaching or exceeding the levels of 90-100% of GDP in many EU member states the deficit of 3% of GDP is too high to prevent the debt-to-GDP ratio from further decrease not saying about the perspective of bringing it back to 60%.

7. The EU secondary legislation called the Stability and Growth Pact (SGP) was to set the disciplining mechanism in respect to member countries' fiscal policies including the use of financial sanctions (only in respect to the Euro Area members) in case of permanent breaching EU fiscal rules. Despite its strengthening in 2010-2011, among others, by making sanctions more automatic (which should be considered as the right decision) the SGP failed to improve fiscal discipline within the EU. The major problem comes from the fact that most of EU member states face problems with meeting the Treaty's fiscal criteria and have been subject of Excessive Deficit Procedure (EDP) in recent years what make them reluctant to impose peer pressure on other 'brothers in trouble'.
8. Another enforcement problem is related to methodological difficulties in ex ante macroeconomic and fiscal projections especially in estimating structural fiscal balances. Governments of individual member states especially those being subject of EDP have strong incentives to present the European Commission projections based on over-optimistic assumptions,

3. Financial Assistance Mechanisms

9. The EU Financial Assistance Mechanisms (FAM) consist several facilities of various size and economic importance. For example, the Macro-Financial Assistance to non-member countries can be considered as the instrument of EU Common Foreign Policy rather than of macroeconomic management within the EU. The EU Balance of Payments facility provided financial assistance to three EU member states not belonging to the Euro Area (Hungary, Latvia and Romania) in 2008-2010. Others (EFSF, EFSM and ESM) has been targeted to the Euro Area members. The European Stability Mechanism (ESM) is the separate international institution founded by the Euro Area members and has the largest financial resources (over EUR 500 billion).
10. The biggest problem related to all FAM which provide financial assistance to EU member states in fiscal troubles is that they undermine, in practice, the 'no bail out' clause in Article 125 of the Treaty of the Functioning of the European Union (TFEU). As result the idea of market discipline in respect to government finances of EU member states (the danger of sovereign default in case of fiscal imprudence) only supplementary supported by the EU fiscal rules and the SGP has been replaced by the practice of conditional bail out[2]. This may create serious moral hazard problems in future.

4. Macroeconomic Imbalances Procedure

11. The Macroeconomic Imbalance Procedure (MIP) was introduced by the EU secondary legislation in 2010-2011 as the part of so-called six-pack, in reaction to European debt

[1] See Dabrowski M (2012): *Fiscal and Monetary Policy Determinants of the Eurozone Crisis and its Resolution*, CASE Network Studies and Analyses, No. 443, http://www.case-research.eu/sites/default/files/publications/CNSA_2012_443.pdf

[2] See Dabrowski M (2014): *Fiscal or Bailout Union: Where is the EU/EMU's Fiscal Integration Heading?*, Revue de l'OFCE, No. 132, April, pp. 19-49, http://www.ofce.sciences-po.fr/pdf/revue/132/revue-132.pdf

and financial crisis but not necessarily its right interpretation. Formally, it aims to monitor competitiveness of individual EU member countries. In fact, its main focus is on monitoring countries' current account balances what raises serious conceptual doubts. In the highly integrated area of unrestricted capital movement such as the EU current account balances and real exchange rate remain outside effective control of national authorities even if country has its own currency. Furthermore, having balanced current account (what seems to be preferred by the scoreboard indicators) is not always necessarily the evidence of macroeconomic health and makes sense. Both historical and contemporary evidence suggests that individual countries can become, for various reasons, capital exporters or capital importers on a sustainable basis (depending on their long-term saving rate and in-country investment opportunities). And the catching-up process assumes capital flow from higher-income to lower-income countries.

5. Mechanisms of 'soft' coordination of national macroeconomic policies

12. Both the new institution of European Semester and period medium-term economic strategies of the EU (the Lisbon Agenda in the decade of 2000s and now the Europe 2020) refer to mechanisms of 'soft' coordination of economic policies conducted by the authorities of EU member states, largely in the areas which belong to their sovereign competences. They seem to have a limited impact on the real decision making process (determined by national parliaments and national politics) on the national level although it may create some kind of useful benchmarks for the national debate and limited mechanism of peer pressure on countries which represent the worst performance.
13. The medium-term economic strategies of the EU set vary ambitious goals which are hardly achievable. This has been the case of both the Lisbon Agenda and Europe 2020 strategy. The major weakness of this approach is that even if the EU strategy's goals are correct and realistic to achieve it cannot offer effective implementation mechanism because most of policy areas involved remain in the national domains.
14. The European Semester is still a relatively young institution but its potential to discipline national fiscal policies remain an open question. Definitely it cannot substitute for the market discipline based on 'no bail out' clause (see Section 3).

6. Banking Union

15. The process of building the banking union may have positive impact on cross-border banking and other financial transactions and, therefore, consolidating the single market for financial services. However, limitation of this project to the EMU members only is its major drawback and may create, in the longer term, barriers between the Euro Area and EU countries remaining outside the single currency.

7. Future evolution of the EMU

16. The Author of these comments considers the single currency project as the integral part of the Single European Market project (elimination exchange rate transaction costs and risk, avoiding potential resorting to competitive devaluation) and the right idea. In my opinion, the so-called Euro crisis was not the crisis of the common currency but result of imprudent fiscal policies in several EMU member countries (and in most other EU member states).

17. In the context of the recent crisis experience the debate on future evolution of the EMU makes sense but not all ideas proposed and discussed (including the concept of the Genuine EMU) well serve its future functioning. In particular, it concerns further developing of bail out facilities and collectivization of debt issuance and responsibility (the idea of Eurobonds) which may further weaken fiscal discipline on the national level and stimulate moral hazard behavior.

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