The Paradox of European Economic Governance: Towards Monetary and Fiscal Union?

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Abstract

The most severe economic downturn since the Great Depression has revealed the underlying problems with the European economic governance that stem from the unusual setup of the Economic and Monetary Union. Although the monetary policies are controlled by the European Central Bank (ECB), the fiscal policies have been in the control of individual Member States, thus, there is no economic union to complement the policies of ECB, which leads to suboptimal outcomes. As it has become clear that cooperation and further integration is needed to counteract the negative externalities, the solutions being developed fall short of guaranteeing the efficient functioning of EMU. The thesis will show that despite the overall agreement that more centralised economic governance is needed, the host of reforms that have been introduced have not delivered not led to a closer union. Paradoxically, rather than taking the EU closer to an economic and political union the interplay of Franco-German duo have weakened the EU institutions, and shifted economic governance towards intergovernmentalism.
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Introduction

The preamble to the Treaty of Lisbon states that the European Union (EU) seeks to strengthen Member States’ economies, advance European integration and create “an ever closer union among the peoples of Europe”.¹ Today, just three years after the Treaty entered into force, the EU is faced with the most severe economic downturn since the Great Depression of the 1930s. As the EU tries to find solutions to the insolvency of Greece, the crisis has led to speculations about the disintegration of the euro area; fiscal austerity advocated as a response to the soaring government deficits has sparked civil unrest and increased political instability in the Member States. Despite the high aspirations of the Treaty, the crisis has undermined belief in the efficiency of the European economic governance, destabilized EU Member States’ economies, threatens the overall course of European integration and calls into question the concept of European solidarity.

Undoubtedly, the Economic and Monetary Union (EMU) that was founded in order to deliver economic and monetary stability by converging Member States’ economies has been successful at setting up the euro and delivering price stability with low inflation. However, over the course of the drawn-out crisis, many have come to accuse the Union of being ill-equipped, or even inherently flawed from inception to deal with crises situations. Although the ad hoc solutions, such as rescue packages for Greece, may have provided temporary alleviation and calmed the markets for the time being, the EU’s response overall has been characterized by indecisiveness and internal turmoil. Therefore, the global economic and financial as well as the unfolding crisis

have put the EU under increased pressure to find viable ways to address the unsustainable situation.

At the heart of the crisis lay both the independence and interdependence of the EU Member States. In general, the aim of national governments is to guarantee the stability of their economic systems, for which monetary and macroeconomic policies are used. In the EMU, however, the euro area governments have delegated the monetary policy-making to the independent European Central Bank (ECB), which leaves the governments in charge of only one of the possible methods of stabilization – fiscal policies. The integration process in the EU has increased the external effects of national policies on the overall health of the single currency. At the same time, integration has rendered inefficient the national policies that seek to counteract negative spill-over effects emanating from other Member States. This leads to a state of interdependence, where the irresponsible fiscal policies of one Member State can threaten the stability of the monetary union as a whole. This instability, however, cannot be countered by one Member State, an individual government’s capacity to unilaterally stabilize the currency union is limited, and therefore, the involvement of all euro area countries is essential.

Within the existing framework of the EMU, the ECB conducts the monetary policy for the euro area, and its main goals include achieving and maintaining price stability in the currency union. There are two main modes of coordination of the fiscal and economic policies of the euro area Member States. First, there is the Stability and Growth Pact (SGP) that establishes guidelines for budgeted deficits and government debt. The SGP represents a rules-based governance method that relies on the monitoring of the Member States’ budgetary developments by the European Commission and the Economic and Financial Affairs Council (ECOFIN). Second, as it became clearer over the years that at least minimum macroeconomic coordination
was necessary, but formal centralized economic governance was politically unviable, the Eurogroup was created. Originally an informal meeting of the finance ministers of the euro zone, the group rose into limelight in the first years after the euro was launched.

Despite the outlined measures, the EU lacks a central supranational fiscal institution that could monitor and coordinate the budgetary policies of all 17 euro area Member States, which would allow the monetary policies pursued by the ECB to be complemented, rather than undermined, by coherent macroeconomic policies. From an organizational standpoint, especially in terms of countering negative externalities and the complementarity of the fiscal and monetary policies, increased centralization of fiscal policies on the EU level would be justified and, as exemplified by the crisis, necessary. Furthermore, the economic integration theory would argue that shared currency is the last stage of integration, which usually starts with a political union. Although the EU embodies the example that a currency union is possible without a political union, it is arguable if this setup can be sustainable in the long run.

It has been noted that “a crisis often stimulates significant governance developments”\(^2\) and as new scenes of the crisis are still unfolding, there is little academic analysis on the most recent changes in the European economic governance and the implications that the numerous reforms have had on the integration process itself. Therefore, the thesis aims to provide an overview of the latest transformations that have taken place in economic governance in the EU. Statements and other relevant documents published by various EU institutions as well as relevant media publications providing current commentary will be used to allow for a comprehensive process tracing and investigate in which ways the Member States and the heads of the EU have reacted to the crisis. Importantly, the focus of the thesis will be on the long-term effects and

implications of these developments for the overall institutional architecture. Although the temporary *ad hoc* response to the crisis, such as establishing the European Financial Stability Fund, will be mentioned in the analysis, the emphasis will be on the long-term solutions and how these have changed the nature of European integration.

The thesis sets a hypothesis that stems from the basic understanding that the EU is an “advanced but incomplete stage of economic integration”. Since the crisis has revealed the week points of European economic governance, it is reasonable to expect that the solution would be an improved governance through the completion of economic integration – this means the achievement of a genuine economic union at the EU level.

Paul De Grauwe has argued that there is a pressing need to finalize this process of economic integration by creating a genuine economic and political union – the current setup has clearly led to an unsustainable situation. Thus, the problem of governance, lack of centralized fiscal policy that could counteract the negative shocks, which have remained considerably substantial in the EU, can be solved with further integration and centralization. This, of course, calls for national governments to delegate more powers to the EU level, a move that is not supported by many Member States. The fundamental question asked in the thesis is whether the EU has answered the crisis by strengthening its supranational character and the Community method, something that has been advocated by De Grauwe and others, as the answer to the crisis. In addition, it will be observed whether the European sovereign debt crisis that tested and proved that the economic governance failed to prevent and mitigate the crisis, led to the finalization of economic union.

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Ultimately, the thesis aims to show that due to the diverging national policy traditions of Germany and France, closer political or economic union has not been achieved, and reforms remain a patchwork of the two policy traditions. Nonetheless, it will be argued that despite the fact that the EU has not taken great steps towards closer economic and fiscal union, the European integration process has not stopped. Rather, integration occurs through an increased intergovernmental coordination of fiscal policies.

The thesis consists of three chapters. The first chapter aims to give an overview of the more recent studies in the field of European economic governance. Emphasis is put on literature addressing the topic of need for economic union to complement the monetary union. The focus is also on authors discussing different ideational influences on the evolution of the EMU. The following chapter provides an overview of some of the most recent reforms in the field of economic governance. The third chapter is devoted to the analysis and explanation of the paradox that emerges from the changes in economic governance.
Chapter 1 – The Storytelling

The EU, which once started as the European Coal and Steel Community that relied on common interests in trade, has by today become one of the most integrated areas in the worlds. Thus, it can be said that the history of the EU has been, by and large, one of integration. Although it is true that there have been instances in time when it has seemed that the EU has reached its endpoint, in hindsight these have not halted the progress towards increased integration. Not surprisingly, then, it has been said that the EU has made some of its most decisive and boldest steps in times of crisis. Although the history of the Economic and Monetary Union (EMU) is considerably shorter than that of the EU, it is facing today a crisis that may well prove to be the making or the breaking of the monetary union. Despite the young age of the EMU, libraries have been produced on the topic of how far the integration in monetary as well as economic union should go, and whether or not the original setup, a centralized monetary policy-making and decentralized fiscal policy-making can guarantee the stability of the currency union.

In order to understand the present, we must know the past. Therefore, the following will firstly provide an overview of the economic governance of the EU up to 2010. Next, it will be explored, keeping an eye on the theories, which would be the logical way to respond to the current crisis, which will allow the formulation of a central hypothesis.

The Stability and Growth Pact

With the creation of the common Economic and Monetary Union (EMU), eleven European Union Member States agreed to the adoption of the single currency, which meant delegating their monetary policy to the independent European Central Bank (ECB). At the same time, the fiscal
policy-making remained the duty of the national governments, which has led to decentralized and fragmented fiscal policies. In 1997, the European Council, when outlining economic policy coordination in the Stage three of EMU, determined that economic policy-making will remain in the hands of national governments that had to adhere to the principles set out in the Stability and Growth Pact.\(^5\) EMU foresaw the national governments as the decision-makers who were given the liberty to decide on the course and implementation of economic policies as long as they adhere to (now) Article 120 of the Treaty on the Functioning of the EU (TFEU), which states that the Member States “act in accordance with the principle of an open market economy with free competition”.\(^6\) The nature of the Maastricht Treaty, which set up EMU’s institutional architecture regarding economic and monetary policy, stemmed from the belief that “monetary union was possible without far-reaching coordination of the economic policies of the involved member states”.\(^7\)

With the “birth” of EMU and the euro, a snowball effect had been started. The question arose how to steer the snowball and which methods for steering should be used. In the most comprehensive analysis of the nature of the Stability and Growth Pact (SGP), Martin Heipertz and Amy Verdun argue that the two leading countries that greatly influenced the shape of economic governance were France and Germany, with the latter more dominating than the former.\(^8\) Heipertz and Verdun show in their study that the paradigm of stability, *Stabilitätskultur*, mixed with the distrust of other Member States, became the *leitmotif* of EMU. Despite

\(^7\) Uwe Puetter, *The Eurogroup: How a Secretive Circle of Finance Ministers Shape European Economic Governance* (Manchester University Press, 2006), 40.
Germany’s reluctance to support economic governance on the EU level, after Stage three of EMU was launched in 1999, Germany’s worries over possible ‘free riders’, countries with poor fiscal history that might run a high budget deficit, intensified. This led to the notorious Article 125 of TFEU, the no bailout-clause, to ensure that Germany (or any other Member State) would not have to pay the debts of another. Nevertheless, the need to reconcile economic coordination and the EU’s control without inferring national sovereignty became evident.

The Stability and Growth Pact (SGP) was proposed by the German Finance Minister in 1995, to clarify the rules on budgets, provide mutual surveillance and establish control over the fiscal policies in the Euro zone. Consequently, Germany endorsed the idea of a rule-based framework that would assure low budget deficit and stability in the monetary union, at the same not requiring the creation of any new institutions within the EU or the drawing up of a new treaty. The SGP has consisted of two components: a ‘dissuasive’ or ‘corrective’ arm, in the form of the Excessive Deficit Procedure (EDP) and a ‘surveillance’ or ‘preventive’ arm that requires Member States to submit yearly stability reports, which outline the governments’ plans to achieve or maintain sound fiscal positions.9

The Pact set out rules to be followed after Stage three of EMU. Namely, national budget deficits had to remain within the 3 per cent of GDP ceiling that was already set by the Maastricht Treaty, national budgets could not exceed 60 per cent of GDP and that over the medium term the Member States’ governments should aim for a balanced budget or budgetary surpluses. The SGP provided a tough benchmark to meet, based on which of their domestic fiscal policies would be monitored by the Commission as well as other Member States. Thus, the SGP came to represent “a German attachment to the notion that states should ‘put their own house in order’ before new

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9 Ibid., 6.
sound European structures could be built”. Not surprisingly then, in France the SGP was seen as a German project resulting in increased fiscal austerity. Although the role of the Economic and Financial Affairs Council (ECOFIN) was reinforced in the SGP, the ECOFIN came to be a mere “policeman acting alongside the ECB”; the new system of economic governance endowed the central bank with unparalleled powers, whereas the ECOFIN, the European Parliament and the Commission remained second rank institutions.

In the context of the SGP, Germany emerged as the initiator of the Pact, whereas France became the leader of the opposition, resisting the inclusion of the German-favoured automatic sanctions in the SGP. The Germans supported an automatic procedure for imposing sanctions in case states failed to comply with the SGP rules, whereas the French advocated a more lenient approach that would have allowed for more room for discretionary policies for national governments. In the end, Germany who gave up the most de facto monetary sovereignty as well as had the strongest economy, had the best position for bargaining over the rules of the SGP as without Germany’s participation the EMU would have been impossible. Thus, Germany managed to push through the majority of its demands. Remarkably, however, Germany failed to guarantee automatic sanctions. The fact that sanctions could not be enforced, became clear in November 2003 when the SGP was suspended by the Council, which marked the failure of the Pact to deliver the stability and compliance that was hoped. More importantly, Germany who had been the advocate for automatic sanctions for non-compliance, together with France had failed to meet the 3 per cent deficit limit. By lobbying enough Member States, France and Germany

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12 Dyson and Featherstone, *The Road To Maastricht*, 790.
managed to block the Commission’s recommendation to start the EDP. By late 2003, this had lead to an intergovernmental opposition on the level of the EU between small Member States, and a Franco-German coalition. The former had accepted the framework of the SGP and expected equal treatment of all Member States, whereas the two most influential countries in the EU had successfully avoided early warning by the Council. Thus, it was clear the SGP “failed in its ambitions”\(^\text{14}\) and needed to be revised. A deal on the SGP was reached in May 2005. Again, the French government’s proposals for reform showed the preference towards more flexible SGP rules that would take into consideration the national political and economic situation. The fact that Germany had repeatedly failed to adhere to the 3 per cent deficit criterion gave France greater political weight to influence the SGP rule\(^\text{15}\), and the reformed SGP came to include country specific “medium-term objectives” before starting the EDP budgetary implications of structural reforms are taken into account.

**The Eurogroup and Gouvernement Économique**

The analysis of the SGP by Heipertz and Verdun, who emphasise the importance of national paradigms that are expressed on the EU level, has regrettably overlooked the emergence of the Eurogroup, which first convened even before the launch of the euro. The European Council Presidency Conclusions in 1997 stated that for the smooth functioning of EMU, the informal ECOFIN Council sessions should monitor Member States economic situation and budgetary developments, and “in order to stimulate an open and frank debate, the ECOFIN Council should from time to time meet in restricted sessions (minister plus one), particularly when conducting

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multilateral surveillance”.16 Thus, the Eurogroup was created as an informal meeting of Eurozone Member states. These ‘restricted sessions’ were originally named the ‘Euro-Council’, which was later changed to the Euro-XI, due to German protests that the term ‘Council’ suggested the body had a legal status. In 2000, when France was holding the presidency of the Council, the Euro-XI was re-named the Eurogroup.17 The group served the function of providing a forum for unofficial debates, which “often stabilize delicate political situations and inter-institutional conflicts”.18 At the same time, the informality of the group has also contributed to the accusations of elitism, lack of transparency and democratic accountability that emanate outside the Eurogroup.

Despite the though analysis of the SGP, Heipertz and Verdun fail to connect the German advocated SGP culture with that of the France favoured gouvernement économique, a body for economic governance in the EU, and see the interplay of these two policy traditions and paradigms. The idea of economic governance, and its necessity in EMU, goes back to the Werner Report (named after Pierre Werner, Prime Minister of Luxembourg) that was published in 1970 and was designed to outline steps to achieve the EMU by 1980. The Werner Report anticipated the creation of a single currency, called for “creating an institutionalized coordination body, defined as a ‘centre of decision for economic policy’, to take the lead in community-wide economic policy”.19 Thus, the proposal of economic governance and greater macroeconomic cooperation suggested by the French is by no means a novel or unprecedented idea in the history of the EU. These attempts, however, were encountered by a strong opposition by the ECB as well.

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18 Puetter, The Eurogroup: How a Secretive Circle of Finance Ministers Shape European Economic Governance, 1.
as other Member States that feared that the empowering the Eurogroup would “lead to a politicization of monetary policy in the euro zone and might even compromise the independence of the ECB”.\textsuperscript{20}

Economic governance is often presented as a way to achieve an ‘effective policy mix’ which should be taken to mean fiscal policy coordination between the Member States and with the ECB to achieve economic growth and reduce unemployment. The French republican tradition has always emphasised the intertwined nature of economic and monetary policies, which should not be separated from each other, and the French history has proven that democratically elected officials can maintain low inflation and a balanced budget.\textsuperscript{21} Furthermore, the Gaullist idea of retaining as much sovereignty as possible in the Union has led the French to support an intergovernmentalist mode of economic governance on the EU level.

Contrary to the French demands of increased intergovernmental economic governance on the EU level that could act as a counterweight to the ECB, Germany’s insistence on the independence of the central bank stemmed from a different political tradition, which tied the idea of ‘sound’ money to institutional independence as it had been with Bundesbank.\textsuperscript{22} The independence of the central bank and focus on price stability had been the cornerstones of German economy ever since the end of World War II.\textsuperscript{23} France argued that price stability is “a matter of political will and consensus building, not of institutional arrangements”.\textsuperscript{24} Furthermore, it was noted that in essence the central bank cannot act as a fully independent body – inevitably the ECB will encounter political pressure. Therefore, the question is where this pressure is acted

\textsuperscript{23} Puetter, \textit{The Eurogroup: How a Secretive Circle of Finance Ministers Shape European Economic Governance}, 55–56.
\textsuperscript{24} Dyson and Featherstone. \textit{The Road To Maastricht}, 785.
out – in some institutional setting, for example the Eurogroup, or left to play out behind the scenes.

**Theoretical background and the hypothesis**

Despite the different conceptualizations of what counted as desirable form of economic governance on the EU level, over time there are clear signs that the euro area Member States moved towards monitoring and coordinating fiscal policies. Although this was rules based and with little sovereignty delegated to the EU level, the Member States had realized that a strong monetary union needs to be complemented with some form of economic union.

More recently, the onset of the crisis in Europe made the fact that the EU is not a political and fiscal union painfully evident. The absence of central fiscal authority that could provide insurance against asymmetric shocks was obvious, and the fact was underlined by both academics as well as politicians. Furthermore, some have gone as far as to assert that “the Eurozone’s future depends critically on its capacity to move forward into a political union”. Furthermore, Paul De Grauwe has claimed that the lack of a closer fiscal union will make it more difficult to exit the crisis, as even a minimal political and economic union would allow to “organize systems of automatic fiscal transfers that provide some insurance against asymmetric shocks”. And as many authors have pointed out, “monetary unions that were not embedded in a strong political union have not survived”. Clearly, this has been realized in the EU and among the Member

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27 Ibid., 2.
States – the past years have witnessed a number of reforms, negotiations, summit meetings, and informal meetings.

Paradoxically, at the heart of the current predicament lies both the independence as well as interference of EU Member States. Governments are exercising their sovereignty by pursuing largely uncoordinated fiscal policies, at the same time interdependence means the unsustainable fiscal policies can have a devastating result for all Member States. Thus, it can be claimed that interdependence creates further need for cooperation and need to delegate sovereignty to the EU level; decentralization, on the other hand, leads to suboptimal policy results. The EU presents a clear case where the fiscal policy-making is decentralized in the hands of Member States and the monetary policy-making is firmly controlled by the ECB. The crisis can be seen as a negative spill over from other dependent countries, which can lead to an imbalance throughout the Union. Thus, the need for coordination is perceived as the only possible way to counter the (negative) externalities. In response, fiscal theory would argue that “the simplest way of ensuring the emergence of collective action is to deprive local, decentralized authorities from the competence over the corresponding policy instrument and to transfer it to the central government”. Within the EU, greater coordination of fiscal and monetary policy would allow taking more decisive steps to tackle the crisis, but at the same time it might prove to be too great of a leap.

On the one hand, it has been argued that the nature of EMU will inevitably lead to centralising economic policies; Especially since there is a need to coordinate fiscal and economic policies

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29 Ibid.
between the ECB and euro area Member States.\textsuperscript{32} Therefore, there is an innate quality to the EU that facilitates more integration and leads nation states to delegate their powers increasingly to the EU level. On the other hand, there is the need to have a centralized budget, more powers at EU level, and necessity to increase institutionalized cooperation.\textsuperscript{33}

Therefore, the underlying hypothesis of this thesis is that over the course of the crisis, when the faults and defects become evident, the EU and the Member States would respond in a manner so as to best address the shortcomings. As it has been argued, this means certain amount of transference of sovereignty, especially in the realm of fiscal policies, to the EU level, possibly with the end result of EMU becoming an economic union. In addition, as the crisis was largely conditioned by diverging fiscal policies, it is expected that economic governance has acquired new and more binding forms that would eventually lead more efficient economic governance.

\textsuperscript{32} Hodson, “EMU and Political Union: What, If Anything, Have We Learned from the Euro’s First Decade?,” 510.
\textsuperscript{33} De Grauwe, “Some Thoughts on Monetary and Political Union,” 25.
Chapter 2 – Overview of Reforms

As the previous chapter demonstrated, there is a need for closer cooperation and the pooling of national prerogatives, so as to achieve more efficient economic governance in the EU. This chapter aims to give an overview of the most recent changes, starting with the European Semester and introduce each of them on chronologically. This allows seeing the evolution of reforms, but also helps to follow the interplay of EU institutions and Member States. The cut-off point is the signing of the TSGC. Although the Fiscal Compact Treaty nor or the ESM have not been ratified by Member States, they nonetheless provide evidence of the changing nature of EU’s economic governance.

Firstly, context will be provided for each of the reforms; it will be analysed which countries and institutions played the most important role in devising the reforms. Treaty and pact documents themselves will be looked at, so as to establish the nature of changes, which institutions are empowered as a consequence, which institutions and modes of governance assume secondary role.

In the light of the unprecedented tensions on the financial market, and fearing a systemic collapse, the Governing Council of the European Central Bank decided to initiate the Securities Markets Programme in 2010. The Programme, which aimed to ensure effective monetary policy conduct, foresaw the purchase of the euro area’s public and private debt securities. Since under the Lisbon Treaty the ECB is prohibited to directly buy Treasury bonds from sovereign debtors, government bonds were bought on secondary markets. By operating on the secondary markets, the ECB has tried to avoid moral hazard developing among EU Member State governments.
Although the activities were conducted on secondary markets, and therefore, technically the ECB did not breach the rules set up by the Treaty, it still constitutes a sharp departure from its previous insistence on the importance of the central bank’s independence that should focus on monetary policy, and not engage in fiscal activities. Despite the ECB framing this move as one that would guarantee the markets’ stability and thereby falling under its financial stability competences, worries over sovereign solvency and politics as well as the pressure to essentially bail out government deficits, played a role in the actions of the ECB.\textsuperscript{34} Thus, over the period of the crisis, the ECB was transformed into a quasi-fiscal agent of the euro area governments.\textsuperscript{35} At the same time, it can be argued that since the EMU lacks the fiscal coordination necessary to complement the monetary policy of the ECB, the central bank was forced into fiscal activities, bailing out insolvent banks and sovereign debtors. The paradox here is that the separation of fiscal and monetary policies was exactly what led to the ECB to pursue fiscal activity. The existence of a fiscal union that would permit the management of public debt to stabilize the monetary union would allow the ECB to do what it was designed to – monetary, rather than fiscal, policy.\textsuperscript{36}

As the ECB’s activities could not prove to be sustainable, action on the EU’s part was clearly needed to remedy the lack of coordination in the EU fiscal policies. The European Council set up a task force on economic governance at the March 2010 meeting, with the purpose of finding ways to strengthen economic coordination.\textsuperscript{37} At the same time, Germany and France were already in bilateral negotiations over the possible reforms, bargaining over the future architecture of economic governance.

\textsuperscript{35} Ibid., 363.
The European Semester

The European Semester constitutes one of the first moves on the EU’s part to reform its economic government in response to the crisis and what is perceived as the cause of the crisis – unsustainable macroeconomic imbalances. The proposal to reform the coordination of national policies came from the Commission in May 2010, and was later supported by a task force on economic governance. It has been noted that the surveillance of public finances as it is now done under the European Semester, was something that had been “around for some time in the thinking of DG Ecfin of the Commission”. Following the proposal, the Member States gave their approval in September.

Enshrined in the Europe 2020 strategy, the European Semester was devised to encourage long-term economic growth and aims to support the coordination of macroeconomic and structural policies between Member States, and first implemented in 2011.

The Semester (See Figure 2) is designed to work as a tool for preventive surveillance of the economic and fiscal policies of the 27 Member States. Previously, little attention was paid to national reform strategies on the EU level; rather, the implementation of new policies was ex post followed by the EU, and the Semester aims to rectify the discord. Essentially, this allows the EU to enforce economic policy coordination on the budgetary process of every Member State. The coordination cycle divides the year into two semesters. In the first half, policy guidance to the EU and euro area is formulated: the European Commission issues the Annual Growth Survey (AGS),

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a report that outlines priority actions that should be pursued at the national and EU level. The report serves as a basis for the European Council for setting economic policy priorities for the coming year. In April, the Member States submit their medium-term budgetary and economic strategies to the Commission and other Member States. In the second half, country specific surveillance takes place – the strategies are then evaluated based on the rules of the SGP and the targets set in the Europe 2020 strategy by the Commission. The Commission’s assessment of individual countries’ strategies serves as the basis for the Council and the European Council to issue country-specific policy advice, leaving the Council to adopt the recommendations. The Commission’s reports in the following year will assess how well the proposals have been followed.41

One of the most important innovations was the submission of the Stability or Convergence Programmes (SCPs) – although the Member States have had to submit SCPs under the SGP, the Semester requires submitting their budgetary projections and plans for fiscal consolidation before they are discussed by national parliaments. This was done hoping that these measures will make the implementation of the SGP more effective. At the same time, this innovation constitutes a problem– since it does not foresee any input by the European Parliament (EP) or national parliaments, the question of democratic input rises.42 Since both of the democratically elected parliaments are being circumvented, the Semester fails to take advantage of the possible ways of

achieving legitimacy and only contributes to the accusations of the lack of democratic surveillance in the EU.\textsuperscript{43}

In addition, several analyses have demonstrated that the Commission’s recommendations have been mitigated and weakened by the Council in their country-specific documents, thereby undermining the integrity of the AGS.\textsuperscript{44} Furthermore, it has become clear that the European Semester has failed to meet the Europe 2020 objectives in employment, expenditure increase on research and improving energy efficiency as most attention is put on budgetary surveillance.

In the end, as the Commission lacks the ability to enforce its decisions, there are no fines or penalties for countries that fail to cooperate, and, therefore, the role of the Commission becomes consultative. At the same time, tougher measures that could be used for pressuring Member States for more compliance would require changing the Treaty, and are therefore unlikely to be taken.\textsuperscript{45} Thus, the European Semester relies on peer pressure, with the possible side effect that the bond markets would use the opportunity to gather information, which means the ECOFIN peer pressure may be complemented with that of investors, thus leading countries to take steps towards consolidation.\textsuperscript{46}

However, by the end of the first European Semester, it has become clear that what was launched with great expectations has fallen short of delivering any tangible results. This can certainly be attributed to the fact that the Commission was lacking teeth in pressing Member States into complying with its recommendations. In addition, it should not be forgotten that over

\textsuperscript{43} Jacques Delors and Sofia Fernandes, \textit{The European Semester: Only a First Step} (Notre Europe, February 25, 2011), 6.


the course of 2011 when it was first implemented, the EU did see a number of new reforms that sought to further economic governance and coordination, thus leaving the Semester in their wake. Rather than concentrating on the implementation and advancement of the European Semester goals, the Euro Plus Pact took the centre stage in economic governance, thereby lessening the importance attributed and attention paid to the European Semester.

**The European Stability Mechanism**

If by the second half of 2010 the steps taken to stabilize the markets and provide leadership were done by the ECB and the Commission, then the European Council meeting in October 2010 can be considered as a major shift towards tackling the crisis by both the European Council and the Franco-German alliance. Firstly, Council President Herman Van Rompuy submitted the results of the economic government task force to the European Council. However, before the European Council meeting in October, Chancellor Merkel and President Sarkozy met in Deauville, France, the same month when it was agreed that the EU needs a permanent crisis resolution mechanism, which would take over the tasks of the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) that were scheduled to end in 2013. Additionally, Merkel was adamant that the future arrangements, unlike the temporary mechanisms, would be anchored in the Lisbon Treaty in order to be “legally unchallengeable”; her proposals also foresaw that the Member States that fail to put limits on their public borrowing, persistently violating euro zone rules would have their voting rights
revoked. 47 This constituted a turn in the Chancellor’s attitude, as previously she had insisted that Germany would support the EFSF only if the mechanism was set up outside the Treaty. 48

In exchange for the French support in this matter, Germany agreed to back the French attempts to water down the automatic sanctions of breaching the euro zone’s limits that were proposed by the Commission to be included in the Six Pack that was being formulated at the time. 49 This came as an unwelcomed surprise to smaller northern countries (Sweden, the Netherlands, Finland) who had insisted on tougher measures, as well as to Van Rompuy, who had managed to shore up a consensus in the task force discussions for tougher penalties for countries that repeatedly break the EU rules. 50 Furthermore, as the statement of the bilateral meeting proposals came at the time when the finance ministers were in negotiations with Van Rompuy and the task force, it “reopened resentments between small and large countries, and between fiscally restrained northern members and indebted southerners”. 51 Not surprisingly, the manner in which the proposal was drawn up and announced underlined the increasing importance and influence of Germany and France, which angered other EU Member States. It is important to note that the watering down of sanctions that was demanded by the two leaders was reversed a year later when predictably Germany, but surprisingly France both pushed for strict rules on penalties in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

Despite the division among the Member States, the European Council agreed on the necessity of a permanent crisis mechanism that would maintain the financial stability of the euro area. Thereby, negotiations with the European Council were started on a treaty change that would not require a new round of ratifications, which would have been time costly, and would not infringe the “no bail-out clause” in the Treaty. In the December meeting, the European Council agreed on the decision amending the Lisbon Treaty in order to set up the European Stability Mechanism (ESM), adding to Article 136 a third paragraph, stating the following:

“The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality”.  

At the same time, it was confirmed that the ESM would involve all euro area Member States and help from the mechanism would be tied to strict conditionality. The Treaty is “open to non-euro area EU countries for ad hoc participation in financial assistance operations”. Also, Member States requiring assistance would be subject to strict surveillance which will be conducted by the Commission, IMF and the ECB. Although initially criticising the setup as diverging too much from the more traditional Community method, as well as for failing to work within the EU framework, the EP backed the limited Treaty change the same month, allowing it

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to be signed by the representatives of the EU Member States after the role of the Commission was clarified in the treaty.\textsuperscript{55}

Importantly, the mechanism has among other rights the tools to purchase the bonds of the Member States on primary and secondary markets (whereas the latter has been done so far by the ECB) and provide loans for the recapitalisation of financial institutions. The ESM and the TSCG are seen as complementary, and cross-conditionality is applied. This means that only those that have ratified the TSCG can apply for financial assistance under the ESM. The mechanism was established as an intergovernmental organisation under international law and is located in Luxembourg.\textsuperscript{56} Although originally foreseen as entering into force in January 2013, this date has been brought forward to July 2012.

At the time when negotiations over the needed Treaty change and the nature of the ESM were going on in the EU institutions and Franco-German duo, there were parallel discussions already under way over how to strengthen political cooperation between euro-area members.\textsuperscript{57}

\textbf{The Euro Plus Pact}

The origin of The Euro Plus Pact, also known as the Competitiveness Pact, and the Pact for the Euro, goes back to a proposal made by France and Germany at a meeting of the European Union leaders in Brussels in February 2011. The proposal outlined steps to improve competitiveness as well as surveillance of macroeconomic and fiscal developments of


\textsuperscript{56} “Treaty Establishing the European Stability Mechanism (ESM) Signed - European Commission.”

participating Members. In the original draft of the Competitiveness Pact, the Franco-German plan proposed rather controversial reforms to be followed by the euro zone and those non-euro area Member States wishing to join. In order to boost confidence in the euro, the Pact foresaw the harmonization of national policies on issues like tax, wages, retirement ages, and adopting “debt brakes” on the constitutional level, which mirrored the German constitution that aims at eliminating structural deficit by 2016.\(^{58}\) Not surprisingly, the Franco-German pact that was “thrust upon”\(^{59}\) the European leaders was countered by a strong opposition in the EU.

Among the arguments against the Pact were concerns that the coordination of policies would be conducted in an intergovernmental method, thereby cutting out the Commission. Guy Verhofstadt, the leader of the Group of the Alliance of Liberals and Democrats for Europe in the European Parliament, argued that one of the faults of the Franco-German plan was the intergovernmental method, which had been proven to lead to failure, citing the example of the Lisbon Agenda that was based on the same means.\(^{60}\) Furthermore, the Parliament expressed fears that the Franco-German proposal would undermine the Six Pack reforms that were under work, and worry over “the creeping intergovernmentalism undercutting the EU legislative process” and the abandonment of the Community method.\(^{61}\) However, as the Franco-German proposal was made at the time when EFSF’s firepower was under discussion, and Germany as Europe’s biggest economy, held the purse to financing rescue packages; the link to Germany’s commitment and desire to commit Europe to fiscal cooperation and surveillance is unmistakable. Merkel made it


clear that she needed to show the domestic public that Europe was willing to commit to stringent rules.\textsuperscript{62} The Franco-German proposal was later revised by José Manuel Barroso, President of the Commission, and Van Rompuy to exclude the most controversial suggestions, as well as to grant that the supervisory role would be left to the Commission. It was noted that the smaller Member States were “angered by Berlin’s tactics”\textsuperscript{63} to undercut the Commission and leverage the system towards bigger Member States. In addition, the Members of the European Parliament were persistent on making the Six Pack, and not the Euro Plus Pact, the foundation for future economic governance.\textsuperscript{64}

Following the agreement of the euro zone leaders in early March 2011, Germany made a commitment to increase the EU's rescue facility from 250 billion euros to 440bn.\textsuperscript{65} Thus, the French hopes of carving the Euro Plus Pact into the basis of a political union and the European Council as the head of this union, failed.

The current version includes the euro area Member States plus six non-euro area countries, namely Bulgaria, Romania, Poland, Latvia, Lithuania and Denmark, and seeks to encourage economic integration so as to enhance competitiveness in the EU. The Euro Plus Pact, a watered down version of the original Competitiveness Pact, builds on the already existing instruments (Europe 2020, European Semester, the SGP) and requires specific commitments from participating Member States that would foster competitiveness and growth in the Member States. The Pact covers mostly areas that fall under national competencies, and pushes for enhanced and voluntary compliance in areas where the EU lacks competence. The goals in themselves are not

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\item \textsuperscript{64} “Preparing for European Council: MEPs to Vote on Stability Mechanism.”
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new; they are mere rehashed versions of the Lisbon Agenda and Europe 2020 Strategy. There has been criticism that the Pact that seeks to enhance competitiveness may face the same fate as its predecessor – the Lisbon Agenda – if it does not learn from past mistakes, and insists on top-down reforms that are not internalized and supported by the public.  

The process outlined by the Pact begins with the Heads of State or Government establishing goals for the Member States, and each country creates its own policy mix with specific goals to be met. Under the new arrangements, these commitments will be included in the National Reform and Stability Programmes that are under the regular surveillance of the Commission. Through the link to the Programmes set out in the European Semester, the commitments and progress towards set policy goals will be scrutinized annually by the Heads of State or Government on the basis of a report by the Commission. Therefore, the policy commitments and follow-up are elevated to the highest possible level, allowing to possibly add to the importance of discussions, compliance and achieving the goals. At the same time, the fact that the Pact lacks sanctions still sets a risk of not adding much value to the overall economic governance setting. Despite the nonbinding nature of the Pact, it “makes economic sense for those countries who want to be seen as good pupils or want to adopt the single currency in the future”.  

Although the Pact was changed in the later stages, it nonetheless signifies a moment of change in Merkel’s attitude towards European economic governance – it has been noted that previously the German chancellor had been reserved and reluctant to take the lead. The proposed Pact,

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however, signifies a transformation – the willingness of the Chancellor to take lead in Europe.\textsuperscript{69} France saw the Pact for Competitiveness as an opportunity to push the idea of a tighter economic government. Since only the euro area Member States were initially included in the Pact, Sarkozy did not see the need for any new institutions to fill the role but instead tried to empower the European Council through the Pact.\textsuperscript{70} Furthermore, the attempt to push through the plan to harmonize taxes and introduce a pan-European tax on financial transactions could be considered to be the first step towards an economic government on the EU level.\textsuperscript{71} However, Germany was adamant in resisting the idea of creating a strong division between the non-euro and euro area Member States, and thus the Pact is open to join for everyone. In addition, the final version of the Pact does not exclude tax harmonization, nor does it include any sanctions for those who fail to comply with the rules set out. Thus, although the Pact may constitute the first step towards \textit{gouvernement économicque}, this step was minor.

\textbf{The Six Pack}

The reforms that constitute the Six Pack were first authored by the Commission, and the task-force chaired by Van Rompuy. Applying to all 27 Member States, the Pack consists of six different measures (five Regulations and one Directive) that are aimed at reforming and strengthening the SGP preventive and corrective arms. As the goal of the regulations was essentially to reform already excising tools, it did not necessitate Treaty revisions and is set

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\textsuperscript{70} Müller and Sauga, “Competing Visions: France and Germany Split over Plans for European Economic Government.”

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within existing EU law. Although the Pack echoes the SGP when insisting that the general
government deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP
(or has to diminish sufficiently towards the 60%), it ensures a stricter application of the debt
criterion – now, the Excessive Deficit Procedure (EDP) can be launched if the debt ratio is above
60% of GDP, or is not sufficiently diminishing.\textsuperscript{72} Therefore, the pack has tightened fiscal
framework and macroeconomic surveillance since entering into force in December 2011.

Importantly, the Six Pack uses reverse qualified majority voting for most sanctions.\textsuperscript{73} This
makes it possible for the Commission to apply semi-automatic sanctions to those Member States
that fail to comply with the set targets. Under the previous SGP, the Commission
recommendations were adopted by the ECOFIN by qualified majority voting. Under reverse
qualified majority voting, the Commission’s proposals are considered adopted unless a qualified
majority of Member States votes against it in the Council. This was done in hopes of making the
blocking of the Commission proposals more complicated. The European Parliament (EP) insisted
on the automaticity of decisions due to the previous experience of Germany and France
overriding the Commission’s decisions. The EP commented that they “do not trust the Council”
and want to rule out the possible repetition of the 2003 situation.\textsuperscript{74}

The reverse qualified majority voting became a thorny subject in the months leading up to the
adoption of the Six Pack, as France (backed by Germany and Italy) was strongly against the
change in voting. France would prefer the reforms to retain an intergovernmental nature, where

\textsuperscript{72} EU Economic Governance “Six-Pack” Enters into Force (Europa, December 12, 2011),
\textsuperscript{74} “Economics Committee Chair on Economic Governance Package: Big Shock for Council,” European Parliament:
Economic Governance Package Explained, n.d.,
the agreements and decisions would be made among the Member State finance ministers.\textsuperscript{75} Therefore, the Member States proved to be reluctant to hand power over to the Commission, in fear of losing control over their fiscal sovereignty.\textsuperscript{76} The Six Pack gives the right to unelected technocrats to review national budgets, contributing to the democratic deficit of the EU. Even though the ECOFIN still maintains its position in having the last word in how countries should remedy their economies, the “institutional battle”\textsuperscript{77} was won by the Commission (and the EP who strongly supported the Commission) by making the non-adoption of the Commission’s proposals difficult. Thus, the Commission is in the driver’s seat. However, as a number of Member States face deteriorating economy, notably Spain, there are already talks of accommodating and not applying fines. This comes only a month after the rules entered into force.\textsuperscript{78} At the same time, Hungary became the first Member State to face the consequences, when the Commission and the Council suspended the Cohesion Funds (starting January 2013) in response to Hungary’s failure to comply with the rules.

Despite, or maybe as a reaction to the Six Pack reforms, Angela Merkel and Nicolas Sarkozy issued a joint letter to Herman Van Rompuy in the following month (December 7, 2011), with their visions for the future, asking for greater commitment to fiscal supervision and austerity.


Importantly, the letter insisted on stronger national ownership and including balanced budget rules in national constitutions. This is discussed more in depth in the following section.

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

In their letter sent to the President of the European Council, Chancellor Merkel and President Sarkozy underlined the need for a closer fiscal union, coordination and the possibility of sanctions for noncompliant members. The message sent by the two heads of state dominated the following European Council meeting, where the 17 Member States agreed with the outlines of the intergovernmental treaty that aimed at putting limits on public spending. The final version of the new Treaty (TSCG, or the Fiscal Compact) was signed in March 2012 by all Member States, except the UK and the Czech Republic. The UK vetoed the treaty at the December meeting so as to win concessions for its financial services sector, later deciding to opt out of the Treaty. The Czech Republic noted that it may join the process at a later stage.

It is important to keep in mind that the TSCG does not fall under the EU law, but is constructed as international treaty, although one that is positioned as compatible with and subordinate to the EU law. It has been noted that as the Fiscal Compact does not have the primacy like the EU law does, the rules in TSCG are “less enforceable”. The decision to position the TSCG outside the EU law stems from the fact that the EU treaty change would

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necessitate all Member States taking a unanimous vote, whereas the TSCG has no such requirement. Since the Treaty obliges the signatory Member States to transpose the balanced budget requirement in national law, there are justifiable doubts whether all Member States manage to ratify the Treaty. However, partly to ensure the ratification of the Fiscal Compact, the Treaty introduces a form of conditionality, tying the permanent bailout fund, the ESM to the TSCG – only Member States participating in the new Treaty will have the right to participate in the ESM. Thus, the TSCG needs only 12 euro area Member States’ ratification to enter into force, and the carrot in the form of the ESM is likely to ensure the ratification in a number of Member States. At the same time, the EP and the Commission, that opposed the treaty as it since it was designed as falling outside EU law, managed to negotiate a compromise by which the international treaty will be incorporated into EU law within five years after the Treaty comes to force.

The TSCG has two main functions – outlining fiscal governance and deepening economic governance overall. The Fiscal Compact element requires that “debt brakes” are set into national legislation at a constitutional or equivalent level, limiting structural deficits to 0.5% of GDP, which, essentially, is the balanced budget rule. The Treaty also envisages an automatic correction mechanism if a country fails to comply with the structural deficit limit. However, the precise form of the correction mechanism is left unspecified. Originally, the framework proposed by Chancellor Merkel foresaw that those in breach of the deficit and debt rules could be taken to the Court of Justice of the European Union (ECJ). This proposal was not accepted and in the current

version only those who fail to introduce such rules to their national law, may be brought to the
ECJ, which can order a Member State to make the necessary changes. The Member States can
bring a case against other signatures of the Treaty to the ECJ, who fail to make correct changes.
The failure to comply will allow the ECJ to fine the incompliant Member up to 0.1% of GDP,
which is not a novelty as monetary fines have been applied in fiscal governance previously, and
have proven insufficient. There is a clear and strong insistence on the compliance with the EU
rules, and the Treaty, especially in the form proposed by Germany, seeks to ensure the rules are
follow. This signals another changed position of Chancellor Merkel, who earlier in the Deauville
discussions had backed France in watering down the Six Pack and opposed the idea of automatic
sanctions. Already in their letter to the President of the European Council, Merkel and Sarkozy
proposed to make the Commission’s proposals binding, although room was left for reverse
qualified majority voting in the Eurogroup, under the planned treaty.85

Notably, the TSCG is concerned with setting up rules of fiscal conduct on the constitutional
level in Member States but not their implementation since neither the ECJ nor the Commission
have the right to interfere in the conduct of national fiscal policy.86 Consequently, the main
purpose of the Treaty, as has been argued, lies in the political statement of the EU Member
States, which allows Merkel to sell the euro rescue deals to the German public. In addition, the
political statement will lend credibility to the common fiscal framework. However, the Treaty
falls short of constituting the first step towards fiscal or political union, since the only lasting
arrangement is the setup of the Euro Summits – informal meeting of the Heads of States or
Government of the euro area. The Euro Summits are to convene after the European Council

85 “Fostering Fiscal Discipline: Angela Merkel and Nicolas Sarkozy’s Letter to Herman Van Rompuy in Full.”
86 Daniel Gros, “The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (aka
meetings at least twice a year, but possibly more often if needed. The meetings are informal and, therefore, cannot issue binding decisions. Non-euro zone Member States are to participate in these meetings at least once a year, and may be invited to join the meetings when deemed appropriate. Thus, the non-euro area Member States are allocated a secondary importance in the meetings. Not surprisingly, this has not been received well by those left outside the Euro Summit meetings – a number of less integrated countries fear that a stronger and tighter Euro-zone would leave “other non-euro countries on the outside looking in” 87 and eventually lead to a “two-speed Europe”. 88

In addition to the informal meetings, the treaty establishes the position of the President of the Euro Summit who, elected for two and a half years by euro zone Member States, oversees the meeting of the Heads of State or Government of the euro area. The President of the Commission and the President of the ECB area also invited to the informal meetings. The formalization of the Euro Summit has also led to a more prominent role for the Eurogroup, which is now responsible for preparatory work for the Euro Summit meetings.

Despite the fact that the TSCG has not yet entered into force, it does serve as an example of a move away from the traditional Community method, and yet another step towards intergovernmentalism. Overall, the Treaty echoes much of the reforms of the Six Pack, including the reverse qualified majority voting, thus the Treaty gives cements the Commission’s powers in the Excessive Deficit Procedure. Although the ECOFIN retains the possibility of voting against the Commission’s proposals, this is more difficult than before. At the same time, the role of the

EP remains very limited, and the treaty obliges the president of the Euro Summit to present a report to the EP after each Summit meeting.

Although Berlin has signalled uneasiness over the possibility of leaving some countries out,\(^8^9\) the fact of the matter remains that the Fiscal Compact has moved the EU further away from the more traditional Community method, and towards a two-speed Europe. There are clear tendencies that the Eurogroup and the Euro Summit are moving into the limelight as the ones to govern the general direction of economic government. Understandably, this raises questions about the role the Commission is left in the governing process as well as the standing of non-euro area Member States.

The following chapter will provide an analysis of the recent changes in European economic governance, and tries to assess whether the EU has moved towards a more unified economic and monetary union. Consideration will be given to the policy traditions that have shaped the process and often dictated the outcomes of reforms.

\(^{8^9}\) Quentin Peel and Hugh Carnegy, “Clash of Styles in Race to Save Single Currency,” *Financial Times*, December 2, 2011, [http://www.ft.com/intl/cms/s/0/020802c4-1d07-11e1-a26a-00144feabdc0.html#axzz1vfzQqCSc](http://www.ft.com/intl/cms/s/0/020802c4-1d07-11e1-a26a-00144feabdc0.html#axzz1vfzQqCSc).
Chapter 3 – Analysis of Reforms

The economic and financial crisis has functioned as a stress test, and as a response to the shortcomings revealed, the EU Member States took decisive steps to reform the economic governance structure of EMU. The Six Pack and the European Semester were introduced on the part of the Commission, whereas the Euro Plus Pact, the TSCG and the ESM were initiated by the two leading countries, Germany and France. The former strengthened the supranational powers of the Commission, whereas the latter were an amalgam of German and French policy traditions and tipped the scales in the favour of intergovernmental method. The motivation for these reforms has clearly been to strive for more efficient and stronger governance and increased coordination on the EU level. Although these reforms have renewed the face of the EU, the more important underlying question is if they have managed to shift the EU towards an economic union, which could complement the monetary union. Therefore, the following chapter analyses the recent reforms, evaluates the efficiency of the changes made, and investigates the possible source of problems.

The move towards intergovernmentalism

The European Semester, which can be seen as one of the first moves on the part of the EU to exercise surveillance on the budgets of EU Member States, may have been launched with good intentions. Nevertheless, the reform fell short of achieving its goals for it lacked tools to enforce the Commission’s recommendations on the budgets of the Member States. Thus, the Commission
did not gain any meaningful power through the reform. One of the interesting side effects of the European Semester, however, is that the surveillance of national budgets has strengthened in the course. Although there are no sanctions for failing to incorporate the Commission’s proposals, and there is evidence that the Council has sometimes watered them down when adopting the country specific recommendations, it is possible to trace some significant tendencies. Firstly, the Commission clearly saw the need for increasing the coordination of budgetary policies, at the same time realizing the importance of abandoning the one-size-fits-all approach. Secondly, since the recommendations are adopted by the ECOFIN, the decisions can prove to encounter the same problem as the SGP in its original form – the politicised decision-making process diminishes the influence of the Commission.

The latter was further strengthened via the Six Pack reforms. However, even though the Commission gained influence through the inclusion of reverse qualified majority voting, in the end the final decisions are still left up to the Council. Again, the objection to automatic decisions signals the reluctance of the Member States, especially France that was adamantly opposed to automaticity, to allow the Commission to dictate rules and gain power. The Commission, which has the potential to become a truly strong supranational institution to coordinate economic and fiscal policies of the Member States, has encountered the mistrust of, above all, France, but also Germany that was backing the former in exchange for support of more controversial proposals of Treaty change. Therefore, there are clear signs that although the EU institutions, particularly the Commission and the EP were trying to shift the scales in favour of the traditional Community method keeping with the Treaty of Lisbon, and strengthen the EU institutions; these attempts, though, were thwarted by Germany and France. Therefore, even within the Six Pack, economic policies are, in the end, controlled by the Council. At the same time, the Commission was left
with the technical role of monitoring and reporting on Member States’ economic performance. Although the Commission tried to act as an institution that could coordinate the fiscal policies of independent EU countries, and therefore, act as a counterweight to the independence of the ECB’s monetary policies, the reluctance of the Member States to see an empowered central institution resulted in a strong intergovernmental turn in European economic governance.

Undeniably, some of the most important responses to the crisis and reforms of economic governance were born out of the Franco-German alliance that saw the introduction of the ESM, the TSCG and the Euro Plus Pact. Importantly, the former two are intergovernmental treaties that fall outside of the EU law. Although the European Council tried to take the lead by asking Van Rompuy to set up and chair a task force on economic governance, the initiative was stifled quite abruptly when Germany and France announced their own plans for reforming economic governance. Thus, even though the European Council’s importance has increased and has in many respects taken over the influence the ECOFIN once had, the more recent innovations have been driven by French-German bilateral leadership, resulting in the reduction of the European Council to the role of rubber stamping the proposals made by Merkel and Sarkozy.

Another remarkable outcome is that the Eurogroup has not emerged as a “fiscal agency of the euro area”\(^90\) as has been suggested by numerous authors. Although the Eurogroup may have gained importance, especially through the TSCG where the group has been given a role of preparing the meetings, this role has become overly technical. When previously the Eurogroup meetings functioned as a policy coordination mechanism as well as a political forum on a larger scale, the Eurogroup has now become more of a technical forum.

scale\textsuperscript{91}, this role has been diminished, and the position of the Eurogroup has become secondary to the European Council, especially in the view of Euro Summits. The latter shows that the need as well as the preference for informal meetings has grown starting from the Eurogroup. Despite informal summits lacking the power to make binding decisions, they nonetheless are powerful and useful means when it comes to policy coordination.

Possible Problems

The overall effectiveness of the Six Pack, European Semester, Euro Plus Pact, ESM and TSCG reforms can be questioned. The reforms of economic governance rely heavily on the exhausted methods of soft and hard policy coordination. However, as the reforms were triggered partly because of the failure of the old system of economic governance, it may be asked how much of added value do these reforms have, especially since previous Commission presidents have noted that an intergovernmental model and peer pressure have failed before.\textsuperscript{92} As the SGP experience showed, the rules based hard coordination failed to prevent the unsustainable fiscal activities it sought to discourage. The soft coordination that is embodied in the European Semester and the Euro Plus Pact has been heavily criticized for its lack of enforcement tools. At the same time, it does not seem that fines have worked in the past. Although in the Six Pack and the TSCG overriding Commission’s recommendations has been made more difficult, the decision remains essentially political and the possibility of the repletion of 2003 exists. The case of Hungary, where noncompliance with the rule has led to the suspension of the Cohesion Funds, should be taken as proof that the reinforced Commission is strict about making use of all the tools

\textsuperscript{92} Verhofstadt, Delors, and Prodi, “Europe Must Plan a Reform, Not a Pact.”
provided and the Council has backed their decisions. However, this is a case of a smaller Member State and the two largest members in 2003 that had more political weight who were the ones to break the rules. Thus, it can be expected that unless new rules and policies are truly internalized and supported in the Member States, there is little the EU or any international treaty can do to make the policies more binding. Clearly, Germany had realized the latter and this explains Merkel’s insistence in the TSCG that the golden rule of balanced budget rules be introduced into all euro area Member States’ constitutional law and the failure to do this would allow the intervention of the ECJ.

In addition to the problematic nature of efficient coordination, it can be argued that the new treaties add another layer of complexities to economic governance. Whereas the European Semester, the Six Pack and the Euro Plus Pact fall within the provisions made by the Lisbon Treaty, the same is not true about the ESM and the TSCG. The new treaties are closely tied to the EU law, meant to function as subordinate to it, and closely linked to EU institutions. Nevertheless, they stand outside the EU law and as such the intergovernmental treaties have only added to the already complex decision-making process. Therefore, the problem of using EU institutions, such as the Commission, for surveillance and other technocratic purposes as well as the role of the ECJ enforcing rules that are technically within the Lisbon Treaty, may bring about grave results in the future. In addition, the cross-conditionality of the ESM and TSCG as well as the fact that a number of non-euro are Member States have decided to be included in these treaties, opting for only certain policies and limiting their cooperation, leads to further confusion. In the end, the decision to leave the solid ground of the EU law and entering the territory of international law may end up hampering rather than helping the final aim of more efficient economic governance.
Patchwork of different traditions

Although the European Council asked Van Rompuy to form a task force for economic governance in early 2011, this was deemed too inefficient by Germany and France who held numerous bilateral meetings and made statements asking for reforms on the EU level. It is clear that over the course of the crisis and crisis management period Germany and France emerged as a duo that took the lead in shaping the European economic governance. It may be argued that Merkel and Sarkozy were frustrated with the slow pace of the intergovernmental method, especially when the UK vetoed the TSCG, which resulted in setting up the Fiscal Compact as separate from the EU law. Overall, the two managed to push their visions through the European Council, and at the same time managed to thwart the plans of the Commission for greater automaticity. Therefore, the independence and influence of the Council can be questioned.

In the reforms proposed and negotiated by the duo, it became obvious that both wanted to develop the EU to fit their political traditions more. The fact that their views on strong governance are rather different has played out on the current setup of rules based intergovernmentalism. The reluctance of other Member States’ governments to pool powers and delegate more prerogatives to the EU level made the German insistence on intergovernmentalism and the rule of law with clearly defined rules a preferred alternative to allowing the automaticity and technocracy embodied by the Commission to take prevalence. At the same time, French insistence on gouvernement économique allowed for increased cooperation without any new supranational institution being formed. Although a new form of meetings, the Euro Summit, was formalized, it remained informal and as such could not adopt any formal decisions. Thus, we can see that Germany, the more dominant of the two, has facilitated France’s insistence on more
coordinated economic governance and the regular meetings of Euro Summit, but also limited it by leaving the meetings informal. Simultaneously, the support of France has allowed Germany to pursue “the elaborate system of rules on which Germany has insisted is necessary to establish a pan-European ‘stability culture’”.\(^93\)

The role of Germany and France in shaping these new reforms should not go unnoticed and unexplored, especially since the duo managed to overpower the European Council in the negotiations for the Treaty on the ESM. The fact that these two Member States have found a way to overcome their different policy traditions has clearly left a mark on European governance. This becomes especially clear when the Fiscal Compact is analysed. On the one hand, the Fiscal Compact Treaty embodies a clear rules based intergovernmental system that guarantees economic policy coordination and is close to German preferences. On the other hand, the formalization of Euro Summit meetings can be seen as a victory for French aspirations to have an exclusive club of Member States that are represented at the ministerial level. After all, Sarkozy has never envisioned a greater role for the EP or the Commission. The \textit{gouvernement économique} has always meant the economic governance and coordination on the Heads of State or Government level, with only euro area Member States being represented. What is more, the fact that the Eurogroup and Eurogroup’s Working Group have been given the task of preparing the Euro Summit meetings can be seen to signal that the agenda has considerable significance and therefore, the influence of Summits may be growing. However, the formalization of Eurogroup, as Hodson has argued, does not have seemed to have worked in its favour.\(^94\) What once was seen as an invaluable meeting forum where candid talk and honest opinions were expressed has now


\(^{94}\) See: Dermot Hodson, \textit{Governing the Euro Area in Good Times and Bad} (Oxford University Press, USA, 2011).
become to be seen as a meeting of technocrats. The position of formulating guiding political positions has been taken over by the European Council, but this may change as the Euro Summit promises to rise in importance.

The preferences of France and Germany meet in the reluctance to empower the Commission and the inclination toward intergovernmentalism. However, when Germany would like to include all 27 Member States in the new treaties (and they are left open for non-euro area countries), France would prefer a close-knit meeting of euro area members. The latter goes to show another dimension of diverging Franco-German interest – whereas Sarkozy supports the emergence of a two-speed Europe, Merkel has proven more reluctant to create deep divides within the EU Member States. One of the reasons for the unwillingness to pursue the idea of a two-speed on the part of Germany may stem from the fact that the meeting of euro area members would exclude Poland, the UK and Sweden – the countries that are more aligned with Germany on economic issues; this would allow France to exercise greater influence in the meetings. Thus, there is still a continuous struggle over how the economic governance will look like in the future. As the current state of economic governance has been a process of negotiations between France, Germany and EU institutions there is no final definition of what strong economic governance in the EU should look like. Rather the process has been hectic, although with clear players, but in the end, it remains in the state of limbo as the more recent reforms are yet come to force and reveal their impact.

Overall, the course of formulating a response to the crisis that has crippled European markets has in many ways gone against the reasoning of those who advocated that the monetary policies of the ECB must be complemented by an economic union. Over the course of the crisis period, it

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95 Staff, “Merkel’s Plan Could Transform the European Union.”
became clear that there is a need to have strong economic coordination and further integration on the EU level. Paradoxically, however, the union’s members are increasingly reluctant to delegate their fiscal policy-making prerogatives and sovereignty to Brussels. Therefore we have the juxtaposition of need for deeper integration and enhanced cooperation, at the same time Member States have proven to be increasingly reluctant to delegated the needed powers to the EU level. Thus, no supranational institutions emerged, even though the Eurogroup was proposed as a possible EU body to take on the responsibility for coordinating Member States’ fiscal and economic policies. Rather, the recent reforms have taken the opposite way and strengthened intergovernmental governance, this especially among the euro-area members who within the last eight months have signed two international treaties that are aimed at strengthening the surveillance of the governments’ budgets. The reluctance of the Member States to give up fiscal policies, something that is seen as very close to the notion of sovereignty, and the paradox of lacking an economic union has been solved by increased intergovernmentalism, which has been influenced by both German rules based stability culture, as well as the French idea of gouvernement économique. At the moment, it seems that the Franco-German alliance has managed to provide an alternative to an economic and political union by opting to maintain decentralised fiscal policies, but with elements of increased soft and hard forms of coordination. However, as the SGP and Fiscal compact have not been ratified and thus have not entered into force, this situation of relative stability may be subject to change, as fears rise that the Member States may fail to ratify the treaties.96

96 The elections in France that saw Francois Hollande come to power have already raised the question whether France s going to ratify the Fiscal Compact (he has signaled a possible renegotiation of the Fiscal Compact’s insistence on balance budget rules).
Thus, the hypothesis formulated was refuted – the European sovereign debt crisis has not mover the EU towards closer cooperation and supranationalism. Rather the opposite has become true. The responsibilities and the overall economic governance has become increasingly muddled and confusing. The fact that the EU has seen the introduction of two international treaties that are closely tied to the EU law have only contributed to the institutional intricacies. Now EU institutions may be required to follow up and inspect requirements that are set up outside the Treaty of Lisbon. In addition, there has not been an emergence on economic union that would have a unified budget. The rules that are set out to deliver better governance both within the EU law as well as outside it, rely increasingly on mutual surveillance and the threat of penalties. This, however, may prove to replicate the same mistakes made in the SGP, where the mere threat of fines did not deter the Member States from breaking the rules.

What is more, increasingly it seems that EU institutions are used for conducting the policies that are instigated by the biggest Member States. At the same time, the insistence of Germany and France on intergovernmental economic governance may pose problems for smaller Member States that have usually favoured the Community method. Furthermore, the belief in rules based governance that does not need to be complemented by improved economic union, has allowed integration to happen only in informal settings, such as the Euro Summit, at the same time leading to a growing divide the euro area and non-euro area Member States.

Paradoxically, then, the reasoning that economic crisis has revealed the weak points of EMU that may be improved in the course of the numerous reforms, has not led to economic union. Instead, the focus and emphasis remains on the individual Member States to get their “house in order” which has been addressed through increased rules based governance, which can be seen as by and large be seen as a repetition the rationale embodied in the original SGP.
Conclusion

The Economic and Monetary Union, one of the core components of the European Union, has led to integration within the EU that has surpassed the expectations of many. The common currency that was introduced into circulation in 2002, and is now shared by 17 EU member states, has only led to further integration. The euro zone countries have delegated their monetary policy making to a supranational level, leaving it to the hands of the European Central Bank. At the same time, member states have retained their control over national fiscal and economic policies. With the beginning of the European sovereign debt crisis, this asymmetry in monetary and fiscal policies has led to an unsustainable situation, where the project of the European Union itself is threatened and the fear of the collapse of the Union destabilizes the markets.

The crisis has left the member states of the European Union at crossroads, situation where difficult decisions must be made and complex problems tackled, the circumstances are not made better by the fact that time is of the essence. European political leaders, including Angela Merkel and Nicolas Sarkozy, have signalled that the dissolution of the euro zone (and by extension the European Union itself) is out of the question and that the only way forward would be to strengthening the Union. As a response to the crisis, the EU has taken decisive steps in the recent years towards better policies and institutions to alleviate the crisis as well as to avoid the repetition of the current crisis.

With the unfolding of the European sovereign debt crisis, the shortcomings of the economic governance and EMU were revealed. Thus, the thesis aimed at reviewing the most recent reforms in European economic governance in order to see whether economic cooperation had been improved, with the view that first substantive steps towards economic union may be taken over
the course of the crisis. Furthermore, it was surmised that the EU would witness a rise of a fiscal union, one that could be used to balance the monetary policies of the ECB. Therefore, the European Semester, Euro Plus Pact, Six Pack, the European Stability Mechanism and the Fiscal Compact were studied and analysed. Process tracing was used to understand the dynamic and the evolution of these policy reforms.

The study showed that although the first step towards appeasing the crisis was the Commission that introduced the European Semester. The institution later initiated the Six Pack reforms, that strengthened the role of the Commission, as the reforms reverse qualified majority voting, that curbs the power of the Council. During the Sic Pack reform, the influence of France and Germany became more prominent. With the backing of Germany, France managed to water down the automaticity that the Commission wanted to introduce so as to prevent the Council from circumventing Commission’s recommendations. At the same time France lent support to Germany when they together introduced the European Stability Mechanism Treaty, which was set up as an intergovernmental organization. A further step was taken towards reforming economic governance through the Euro Plus Pact that was introduced to the euro area Members, but is also open to non-euro area governments. Essentially the Euro Plus Pact sought to coordinate policies that fell outside the EU competences. However, as it again lacks the tools to enforce those who do not comply with policy goals they have set for themselves, this becomes a soft tool for coordination, and its value added may be questioned. Last but not least, the Fiscal Compact Treaty was launched, which was introduced to the euro area governments as an intergovernmental treaty. The Fiscal Compact only adds to the overall economic governance as the functions, rights of EU institutions under the international law are unclear. Further, the Treaty
that introduced many of the reforms Merkel had originally envisaged in her letter, only reinforced the reluctance Member States accept the strict rules of balanced budget in their constitutions.

Overall, there is a clear tendency that the EU has moved towards intergovernmentalism. This has led to the stricter division of euro area and non-euro zone members with the latter understandably worried over their second class status and exclusion for Euro Summit and Eurogroup meetings. One is clear, however, the answer to the European sovereign crisis on the part of the EU has not been a closer economic or political union, rather the opposite. Paradoxically, greater need for cooperation and integration has been facilitated through increased intergovernmentalism.
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