Social developments in the European Union 2011

Thirteenth annual report

Edited by
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European Trade Union Institute (ETUI)
European Social Observatory (OSE)
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Summary

This chapter analyses the EU and the Eurozone’s fitful and uncertain search for better economic governance through the aftershocks of the biggest financial crisis to hit the developed world since 1929. It follows Wolfgang Streeck (Streeck, 2011: 1) in interpreting the Eurozone crisis as an attempt to resolve an inherent tension between capitalist markets and democratic politics, with a flawed Eurozone polity struggling to cope with a largely unreformed neo-liberal order, despite the glaring weaknesses of efficient market theory as exposed by the 2008 banking crisis. It describes the significant shifts in thinking that have had to be made by Eurozone leaders in the torrid three year period since then, from initial ‘integration fatigue’ and emphasis on the primacy of national action in the final months of 2008, through the conclusions of the Van Rompuy task force on economic governance reforms in 2010 to the Eurozone decision in December 2011 to negotiate a new treaty for a ‘fiscal stability union’.

However, the chapter argues that the proposed settlement can hardly be regarded as final. First, it contains economic flaws of its own in seeming to set Europe on a course of unremitting collective austerity without a plan for growth within a necessary and robust framework of fiscal discipline. Secondly, it remains unclear how the planned closer coordination of economic policies will address directly the problems of divergent competitiveness which lie at the heart of the Eurozone’s fiscal and banking problems. Thirdly, it raises major unresolved political questions about the relationship between stronger Eurozone governance, more intrusive of national sovereignty over a broader agenda, and in part enacted through an
international treaty not formally part of the EU structure, on the one hand; and the legal order of the EU27 on the other, where non-Euro members may or may not be signatories to the new treaty. The German Chancellor describes the measures taken to resolve the Eurozone crisis as a ‘step by step’ process that will take years before the problems are finally resolved. In that judgement she appears to be right.

The chapter concludes by assessing the prospects for a new model of European economic governance. It argues that the framework is limited because while the proposed structure genuinely seeks to address the challenge of coordinating very different national economies, there has been too little attention paid both to financial regulation and the need for a new growth agenda as an alternative to the politics of austerity. This chapter complements other contributions to the volume, including Amato and Meny’s analysis of the institutional dynamics involved in EU economic governance reform, and Degryse and Pochet’s focus on the limits of the austerity paradigm.

1. A framework for understanding the crisis

The global economic crisis that was unleashed on the world economy in 2008 has had a seismic impact throughout the developed world - deep recession and an explosion of public debt across the advanced capitalist countries, on top of which, in the Eurozone, came a crisis of sovereign debt and flawed economic governance. While many Eurozone politicians point the finger of blame for the crisis at a flawed model of Anglo American financial capitalism, the crisis has wreaked havoc on many of Europe’s banks and plunged many EU Member States into deep fiscal crisis, straining the Eurozone to breaking point. At several points in the last three years, policy makers have hoped that the worst of the crisis had passed, but as of writing, this optimism appears fragile. The European and global economy have been hit by a series of damaging ‘aftershocks’. The overall impact of the global crisis, and the highly specific governance crisis of the Eurozone, which it has brought in its train, is far from over.

The German political scientist Wolfgang Streeck has argued that the ‘great recession’ and subsequent collapse of the public finances ought to be seen as the manifestation of a basic underlying tension in western
capitalist societies which makes instability and disorder ‘the natural order of things’, rather than equilibrium and consensus. This is the ‘endemic conflict between capitalist markets and democratic politics’, which has helped to shape the present global crisis. In the post-war period, there was a general acceptance that markets ought to be subject to various forms of political control through Keynesian macro-economic management, public ownership, the welfare state and corporatist social partnership in the labour market. This basic compact fell apart in the capitalist crisis of the late 1970s, however, and notions of ‘market forces’ and ‘welfare needs’ were seen as increasingly incompatible. That led to a wave of deregulation, marketisation, privatisation and neo-liberal hegemony in the policy agendas of many advanced industrial economies. Streeck argues persuasively that the crisis of 2007–2008 is but a further stage in the crisis of post-war capitalism, characterised by the inability to reconcile politics and markets. This is seen in the collapse of a ‘privatised Keynesianism’ in which financial deregulation had enabled working families to obtain easier access to consumer and mortgage debt, particularly in the Anglo American sphere, but also in Spain, which is now unsustainable. In the three years since 2008, distributional conflict under democratic capitalism has turned into a complicated ‘tug of war’ between global financial investors and sovereign nation states …it is now financial institutions wrestling with the very states that they had only recently blackmailed into saving them’ (Streeck, 2011: 1).

In the European case the parallel projects of the Single Market and single currency, originating in the 1980s, can be interpreted as an attempt to accommodate the neo liberal economic tide in thinking and the rising power of financial markets within a European framework of deeper economic integration. These projects were motivated by political ambitions for greater unity that have proved flawed and incomplete. The EU has been struggling with that challenge ever since the collapse of Bretton Woods, first with the EMS/ERM experiment and then with the single currency. The financial crisis and the more recent turmoil in sovereign debt markets have highlighted underlying structural weaknesses in the EU’s economic governance arrangements. As Chancellor Merkel and President Sarkozy put it, ‘the current crisis has uncovered the deficiencies in the construction of EMU mercilessly’ (Embassy of the Federal Republic of Germany London, 2011). In order to address these challenges, there has to be a fundamental shift commensurate with the degree of economic and financial integration already achieved through
monetary union and the internal market. The former chairman of the US federal reserve, Paul Volcker, has analysed the nature of the European crisis thus:

‘At its roots are years of growing imbalances within [...] the Eurozone [...] The ability to borrow at low rates bridged for a while the proclivities of some countries to spend and import beyond their means, while other countries saved and invested, tending to reinforce an underlying gap on productivity between national economies. [...] Financial practices helped sustain such imbalances...Among nations dedicated to a common market and common currency the tensions are great. The plain implication...is not to retreat from an integrated Eurozone. Right now, it is a question of building protection for European banks and countries that are at risk and faced with financial breakdown. Ultimately what is needed is a new institutional structure that will require greater consistency in banking and financial standards and more broadly, will also require stronger discipline in fiscal and economic policies’ (Volcker, 2011: 3).

Deeper integration may be seen as inevitable given the extensive nature of economic interdependence in Europe, although the possibility of a break-up of the Eurozone cannot be entirely ruled out. How to define the nature and reach of this necessary further political integration, while preserving the democratic legitimacy of the nation state as regards its key responsibilities for fiscal and economic policy, is the tough and difficult issue that the EU and Eurozone are trying to resolve. Following Streeck’s argument (Streeck, 2011), this might be seen as an attempt to further reintegrate capitalist markets and democratic politics, explicitly acknowledging that nation states are no longer sovereign actors and cannot pursue policies unilaterally.

Arguably, integration is desirable whether or not Member States are euro members, though the political obstacles are formidable. Remarkably for example, British exports are now more dependent on the EU, and therefore its economic health, than it is the case with Germany. This reflects both the scale of overseas inward investment in the UK, precisely in order to take advantage of the EU single market, as well as Germany’s more successful reach into emerging markets.
2. **The point of integration currently reached**

Concepts of what the EU and Eurozone need to do to reform economic governance have undergone a revolution in the space of three torrid years. In 2008, Europe’s initial responses to the banking crisis were intergovernmental in method and prioritised action by the nation state. By the end of 2011, the Eurozone had signalled its intention to create in a new treaty a ‘fiscal stability union’.

A key staging post had been the recommendations of the task force on economic governance (European Council, 2010a: 1). The task force had been set up by the March 2010 European Council to present ‘the measures needed to reach the objective of an improved crisis resolution framework and better budgetary decision, employing all options to reinforce the legal framework’.

The new governance agenda agreed by the task force falls under five broad headings, as set out in the report’s recommendations summarised below (European Council, 2010b):

<table>
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<th>Greater fiscal discipline</th>
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<tr>
<td>- The Stability and Growth Pact ... applied in a better and more consistent way [with] a greater focus on debt and fiscal sustainability.</td>
</tr>
<tr>
<td>- Operationalise the debt criterion in the Treaty by defining an appropriate quantitative reference.</td>
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<tr>
<td>- A wider range of sanctions and measures applied progressively in both the preventive and the corrective arms of the SGP.</td>
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<tr>
<td>- A higher degree of rule-based decision making [based on] a reverse majority rule: Commission recommendations would be adopted unless a qualified majority votes against.</td>
</tr>
<tr>
<td>- Agreed minimum requirements for national fiscal frameworks... reflecting the EU’s fiscal rules.</td>
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<th>Broadening economic surveillance</th>
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<td>- Compliance with the SGP not sufficient to ensure balanced growth.</td>
</tr>
<tr>
<td>- A new mechanism for macroeconomic surveillance underpinned by a new legal framework alongside the budget-focused SGP.</td>
</tr>
<tr>
<td>- Annual assessment of the risk of macroeconomic imbalances [by] the Commission.</td>
</tr>
<tr>
<td>- An ‘excessive imbalance position’ should be launched by the Council: Euro area Member States may ultimately face sanctions in case of repeated non-compliance.</td>
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Deeper and broader coordination

- ‘European semester’, implemented as of 1st January 2011.
- Simultaneous assessment of both budgetary measures and structural reforms.

Robust framework for crisis management

- The European Financial Stability Facility (EFSF) for the euro area [already] set up and now fully operational for the next three years.
- Need to establish a credible crisis resolution framework for the euro area capable of addressing financial distress and avoiding contagion, resolutely address[ing] the moral hazard implicit in any ex-ante crisis scheme.

Stronger institutions for more effective economic governance

- Stronger institutions both at national and EU level will contribute to improve economic governance.
- At the national level, the use or setting up of public institutions or bodies to provide independent analysis, assessments and forecasts on domestic fiscal policy.
- Task Force recommendations will result in substantial strengthening of the economic pillar of the Economic and Monetary Union.
- Adoption of the secondary legislation [recommended] on ‘fast track’.

Since then a treaty change has been ratified under the ‘simplified revision procedure’ to establish the European Stability Mechanism on a permanent basis, eventually to replace the EFSF. Its date of operation has been brought forward to 2012 to operate in parallel with the EFSF, increasing the Eurozone’s ‘firepower’ to address the crisis (European Council, 2011a).

In addition, the so-called ‘Six Pack’ of legislative changes to implement in full the Van Rompuy task force recommendations was agreed under the full process of co-decision between the Council of Ministers and the European Parliament within twelve months, entering into force on 13 December 2011. The Parliament played a critical role in resisting French attempts to weaken the new ‘reverse majority’ procedure, despite the Germans making a concession on that point at the Franco-German summit at Deauville earlier in the year (European Parliament, 2011).
Why then did the European Council feel it necessary to go further in December 2011 and insist on the need for further treaty change? Two distinct strands of motivation are clear. First and foremost was the German desire to see a ‘new fiscal compact’ enshrined formally in treaty change. The content of this compact includes:

— The quantitative limits on deficits and debt

— The establishment of new independent institutions at national level to monitor compliance with the reference criteria

— The collective monitoring of both national budgets prior to their approval by national parliaments and also of Member State debt issuance plans

— The new quasi-automatic sanctions at Euro level with Commission recommendations only being over-turned by the high hurdle of ‘reverse QMV’.

In his own recommendations to the December 2011 European Council, its President, Herman Van Rompuy argued that the substance of what Germany was seeking could be achieved by legislative change within the existing treaties (European Council, 2011b). Many Member States were sympathetic to the Van Rompuy view, and fearful of the political hazards of treaty change. Yet they went along with Germany because they judged the political ‘optics’ of a new treaty essential to reassure German public opinion. Many hope that this constitutionalisation of fiscal discipline will restore lost trust between Member States and enable an effective ‘firewall’ of collective guarantees of Eurozone public debt to be put in place at some point not too far in future, through some mix of an increase in the scale of resources available to the EFSF/ESM, an ECB commitment to buy bonds without limit to stem market panic, or steps towards Eurobonds.

The second motive behind the new treaty is a recognition that ‘more active use of enhanced cooperation on matters which are essential for the smooth functioning of the euro area, without undermining the single market’ as well as ‘working towards a common economic policy’ is essential within the euro area (European Council, 2011c: 4). The idea of a competitiveness pact for the Eurozone first emerged at a Franco
German summit in early February 2011. It caused an enormous storm then, as a result of both its controversial content and chosen method. The content included proposals to end wage indexation, raise pension ages and harmonise corporate taxes, causing predictable furore from Member States as diverse as Belgium and Ireland. Paul Nyrup Rasmussen, the President of the Party of European Socialists, denounced the proposed pact as an ‘austerity juggernaut’ (PES, 2011). Guy Verhofstadt, the leader of the Liberals in the European Parliament, accused France and Germany of trying to impose policies through an intergovernmentalist backdoor that sidelined the Community method and its institutions (BBC Democracy Live, 2011). The Polish government believed that it was unacceptable for the Eurozone to agree on closer economic policy coordination that excluded non-Euro Member States like them who were obligated by the treaties to join the Euro at some future point. The outcome was the Euro Plus Pact of March 2011 (European Council, 2011d: 13): This Pact focuses primarily on areas that fall within national competence and are key for increasing competitiveness and avoiding harmful imbalances. [...] Other Member States are invited to participate on a voluntary basis.

23 of the EU27 agreed to do so. Only the Czech Republic, Hungary, Sweden and United Kingdom stood aside. The Pact talked about its signatories agreeing, *inter alia*, on common economic objectives and on an annual basis, ‘national policy commitments’ to meet them, ‘with their own policy mix, taking into account their specific challenges’. The policy areas the Pact will cover include:

- ‘Wage and productivity developments and competitiveness adjustment needs’;
- ‘Sustainability of pensions, health care and social benefits’;
- ‘National fiscal rules’;
- ‘Tax policy coordination’.

The Franco-German letter preceding the December 2011 European Council reiterated the argument for further moves to strengthen common economic policies. However, in an important development on the Euro Plus Pact, the letter demanded *faster progress in specific
areas’ where the EU has a clearer competence (Embassy of the Federal Republic of Germany London, 2011). It listed financial regulation; labour markets; convergence and harmonisation of the corporate tax base; and growth supporting policies and more efficient use of European funds in the euro area. However, this agenda was not listed in the final Council Conclusions [8 op. cit.], doubtless to maximise support for the treaty change proposal among Member States like Ireland and the Eastern Europeans who traditionally have opposed any measure of corporate tax harmonisation.

The seventeen EU Member States within the Eurozone have arguably in just over three years, admittedly as a result of force majeure, confronted the need for greater fiscal and regulatory integration. Also all EU Member States except the United Kingdom and the Czech Republic agreed to consider with their national Parliaments joining the Eurozone on this journey. As the December Council Conclusions cryptically note: ‘considering the absence of unanimity among the EU Member States’, [the euro area heads of state or government] ‘decided to adopt them through an international agreement to be signed in March [2012] or at an earlier date. The objective remains to incorporate these provisions into the treaties of the Union as soon as possible’ (European Council, 2011c: 7). The treaty logic of this position is indisputable. The Treaty of Maastricht in 1992 committed all EU members to joining the single currency as soon as they fulfil the criteria and are judged economically ready to do so: only Denmark and the UK, won formal opt-outs from these provisions. The French may well prefer to see a tighter intergovernmental model of economic governance develop on a permanent basis, but that will only happen as result of a deliberate choice on the part of Britain and possibly other Euro-outs, to reject formal incorporation of these new arrangements into the European treaties.

3. The glass half-full: the political and policy shift to ‘more Europe’ since 2008-2009

To understand the current context of European economic governance, it is necessary to step back and examine how the global financial crisis has fuelled the partial shift towards further European integration over the last four years. This is a diachronic approach which examines institutional evolution in the EU across time (Hay, 2002). In the ‘Anglo sphere’, the
Eurozone is constantly criticised for its failure to ‘get ahead of the markets’ and to ‘get on top of the crisis’. The Eurozone leaders are attacked by free market American and British political commentators for their ‘obsession’ with institutions and their neglect of the policy changes they see as necessary to resolve the crisis: typically a mix of action on the part of the ECB to act a lender of last resort, the need for EU-wide bank recapitalisation, and the introduction of some form of Eurobond. In the authors’ view, there are strong merits in all of these recommendations and some progress towards them could be made within the existing framework.

However, those expressing these frustrations fundamentally misunderstand the nature of the EU polity. There is no strong executive body empowered at present to act in these ways. The EU is a constitutional order defined by the treaties signed between its members. In this constitutional order, it is inevitable that process has to come before policy. Indeed process shapes what policies are possible. More than in any other polity, the constitutional rules embody the limits of what a Union of sovereign nation states can achieve. It is an irony that those who are most Eurosceptic are often those who criticise the Union loudest for its alleged failure to trample on the sovereignty of its Member States and set aside the treaty rules that determine what they have agreed to do together and what they have not. Inevitably the development of thinking on economic governance from 2008 to 2011 has not been without contradiction and tension. The brief analysis that follows highlights the significance of the progress made before we turn to the problems that continue to blight the framing of a coherent governance response to the Eurozone crisis.

3.1 Eurozone governance: the shift in power to Heads of Government

In the midst of the 2008 banking crisis, Sarkozy, as the then holder of the EU rotating presidency, called an informal summit of Eurozone leaders. In itself this was a huge innovation. Back in 1998/1999 Germany had strongly resisted the French Socialist enthusiasm, when Dominique Strauss Kahn was Finance Minister, for a ‘gouvernement économique’ of the Eurozone. All the Germans were prepared to concede at that time was the establishment of an informal ministerial
The EU and Eurozone’s fitful search for better economic governance

Eurogroup of finance ministers that met in advance of the monthly Ecofin meeting. The Eurogroup ‘informals’ quickly grew in importance. The Eurogroup Finance Ministers elected in 2005 their own president in the shape of the Luxembourg Prime Minister and Finance Minister, Jean-Claude Juncker. However, until 2008 Germany had resisted Eurozone meetings at the level of heads of government, on the grounds that such highly political gatherings posed a threat to ECB independence. By 2011 Merkel and Sarkozy had proposed, and the Eurozone agreed, that heads of government would formally meet twice a year under their own permanent President and for the duration of the debt crisis at least monthly. This is a hugely important institutional development for the Eurozone – and of course for the EU27. For good or ill, national political leaders have got the upper hand over finance ministries and central bank technicians in managing the Eurozone.

3.2 Progress in overcoming ‘integration fatigue’

The EU has gradually overcome the visible ‘integration fatigue’ that was initially a drag on effective collective action. The sovereign debt crisis first broke after PASOK’s victory in the October 2009 Greek elections and the new government’s admission that the fiscal deficit would be far higher than previously claimed. There was little appetite for strong leadership from the Brussels institutions or further integrationist steps. The Lisbon Treaty was completing its tortuous path to final ratification in November 2009. It itself had been born of the failure of the Constitutional Treaty to secure ratification as a result of the French and Dutch referenda in 2005. The whole process from start to finish had taken no less than eight years from the initial Laeken Declaration. The lack of enthusiasm to put the EU at the heart of crisis resolution had already been on display in the response to the debt crises that had hit non-Euro EU Member States such as Hungary, Latvia and Romania in the immediate wake of the banking crisis; the IMF eventually took the lead with the EU in a supporting role. As the Greek crisis mounted in the New Year, the essential disposition of the Eurozone, led by Germany, was that it was one of national fiscal irresponsibility (and cheating) which should not be resolved by unjustifiable ‘transfers’ from other Member States: the Greeks fundamentally had to sort themselves out through tough measures of austerity and reform. However it quickly became clear that the bond markets would no longer lend to Greece at sustainable levels of interest.
Yet at this stage, the major concern in Chancellor Merkel’s mind appeared to be to avoid a politically controversial bail-out until the important Land elections in North Rhine-Westphalia were out of the way. An emergency summit, held on the same weekend as these elections, was intended to provide liquidity for the period that Greece could no longer access the private markets. This support was only made available at penally high interest rates and on the basis of strict conditionality. To facilitate the collective bail out, it was agreed to set up two new institutional mechanisms – the Eurozone EFSF and the smaller EU wide EFSM. These decisions represented a significant shift from a reliance on national responsibility to an acceptance of the need for collective action. Yet the mechanisms chosen were intergovernmental rather than supranational. In an emergency situation there may have been no alternative to a temporary ‘side’ agreement between Member States to set up the EFSF. However when Mrs Merkel later insisted that the permanent European Stability Mechanism had to be ratified by treaty change, there was nonetheless little inclination to ‘federalise’ decision making in the ESM on the model of the ECB. Instead decision making would be by unanimity, in order (in a comment allegedly attributed to Chancellor Merkel) ‘to keep control of our money’. The decision making rule of the ESM was eventually changed to an 85% majority by the December 2011 European Council. Germany lost nothing of course by this, but threats of veto by a Slovakia or Finland would no longer obstruct progress.

3.3 Stronger though flawed German commitment

Germany had been strongly criticised for the lack of leadership at first evident in the Eurozone. Many commentators now argue that if the Eurozone had acted quickly to restructure Greek debt and deal with the consequent banking fall-out, this would have proved perfectly manageable. Greece accounted for less than 3% of the Eurozone's outstanding public debt. The sovereign debt crisis would not then have gathered the vicious momentum that developed over the succeeding eighteen months. Yet when the crisis broke, there was limited governance capacity in place to make this happen, and still more limited political will to fill the governance gap. In 2010 there was a fashion for writing articles about how Germany had fallen out of love with Europe and the Euro.
However, the second half of 2011 saw a definite pro European swing in the mood of the German political class, even if public opinion remained more divided. Merkel began to act on her declaration that ‘if the Euro fails, Europe fails and for Germany that would be unthinkable’ (Deutscher Bundestag, 2010). On 29 September, the Bundestag voted by 523 to 85 in support of an expanded EFSF with Merkel’s CDU-CSU-FDP coalition not having to rely on the opposition Greens and Social Democrats to secure an overall majority (Deutscher Bundestag, 2011: 46). At the CDU’s annual party congress in Leipzig in November, a strong resolution was passed reaffirming the party’s commitment to Europe and to a new treaty to take forward economic and political union (CDU, 2011). Mrs Merkel herself came out for a new treaty to establish a fiscal stability union, arguing that wider political reform would be a matter for later. The content of German policy to save the Euro may still be flawed, but the will cannot now be in dispute.

3.4 Fresh signs of life in the Brussels institutions

The Brussels institutions have begun to assert some leadership. When the crisis first broke, the European Commission, the body charged by the Treaties with responsibility to look to the European interest, was ‘hors de combat’. It was near the end of its five year term and in a weak position. Its President, Jose Manuel Barroso, felt politically constrained, given the imminent decision on his reappointment by the European Council and his need to secure European Parliament endorsement. The Commission suffered another huge blow when the newly appointed permanent President of the European Council, Herman van Rompuy, was invited to chair the task force on economic governance. In terms of the institutional balance within the Brussels system, this was a significant personal set back for Barroso and a deliberate sidelining of the Commission. It also reinforced an unfortunate separation between the new economic governance agenda, now under the leadership of the President of the Council, and the Commission’s legal responsibilities for the internal market and structural economic reforms.

The leadership of the Commission had been at fault in not focusing on the potential gravity of the gathering sovereign debt crisis. It might be argued that the leadership appeared trapped in a ‘Brussels bubble’ as it put its energies into devising and presenting its new ‘Europe 2020 Strategy’ to
replace the ‘Lisbon strategy’ launched ten years previously (European Commission, 2010). The worthy aim was to establish a clearer priority for structural reform than Lisbon, which had become criticised for the diffuseness of its objectives and weak implementation. The European Council rhetorical commitments to this strategy remained high.

‘Structural reforms are essential for a strong and sustainable recovery and preserving the sustainability of our social models. Jobs and social welfare are at stake. If we do not act, Europe will lose ground. The European Council’s responsibility is to show the way ahead’ (European Council, 2011e: 25).

A diverse range of structural reform targets were agreed:

— 75% employment rate;
— 3% of GDP to be devoted to public and private R&D;
— The 20-20-20 targets for reduced greenhouse gas emissions, the share of renewables in final energy consumption and energy efficiency;
— Targets to reduce school drop out rates and increase the share of the population with tertiary education or its equivalent;
— A new target for a reduction in child poverty.

Member states undertook to translate these EU wide targets into national targets and produce annual National Reform Programmes. The Council agreed various procedural reforms that were intended to ensure that implementation of Europe 2020 was taken more seriously than Lisbon had been.

The whole exercise however plainly lacked much sense of political urgency or real Member State buy-in. The consequence was that the EU went into the crisis with a plan for growth that was a sideshow. What should have been a set of reform priorities to offset the negative effects of fiscal austerity on growth was not properly integrated into the governance objectives for handling the sovereign debt crisis. Nor was there much visible attempt to see how existing EU instruments could be used to support Member State structural reforms – for example,
through better use of Structural Funds and the mobilisation of the EIB’s capacity to borrow at low interest rates. The Commission talked of bold ambitions to re-energise the Single Market and reform financial regulation in the wake of the crisis, but these had not been integrated into a coherent and comprehensive agenda for addressing the crisis.

These problems have not gone away since 2010. However, Van Rompuy has established himself as an important player in frequent European Council and Eurozone summit meetings. He offsets the pull towards intergovernmentalism that the increasing importance of the Franco German ‘couple’ exerts, led by Sarkozy. He has also proved his worth as a voice for the concerns of the smaller Member States. The broader economic governance agenda, to which the Eurozone has now committed itself, creates an opportunity for the Commission to develop proposals for structural reform at EU level which could be implemented for the 27 as a whole or for the Eurozone under an enhanced cooperation (with the likelihood that many Euro-outs would join in). The Commission has also begun to reassert its independence and authority as an institution – even if this means angering the German government – as shown in the proposals they presented for Eurobonds (European Commission, 2011).

3.5 New priority for financial regulation, but nowhere near enough or properly thought through

The Eurozone has made some progress in recognising the central linkages between the sovereign debt crisis and the need to reform Europe’s financial sector. In 2008, Sarkozy had invited the then British Prime Minister Gordon Brown to the Eurozone summit in order to explain the drastic emergency measures of bank recapitalisation that the United Kingdom had been forced to take. The Summit resolved to follow the British example – on a national basis, with each Member State committing to sort out the problems in its own banks. In the immediacy of the crisis, the decision to adopt a national approach made sense. Bank rescues require large amounts of money, which, in the days or even hours available to stem the crisis, only national fiscal authorities with the power to tax could provide. Yet a national approach is also inadequate. As a result of the Single Market, cross-border interconnectedness within the EU banking system is highly developed.
As the sovereign debt crisis unfolded, this interconnectedness became ever more apparent. French and German banks are massively exposed to Southern debt. British banks are in a similar position in the case of Ireland and Spain. The complex hedging instruments that financial institutions have traded with each other have unquantifiable cross border ramifications for financial stability. As Nicolas Véron has consistently argued, ‘a single European body should provide a consistent assessment of all Europe’s big banks’ capital position as the basis for a credible recapitalisation plan. Member States should be prevented from using domestic financial firms as crutches to their own credit problems, to the peril of depositors and borrowers alike’ (Véron, 2011: 1).

Only modest progress had been made towards this goal. Many Member States have traditionally seen ‘their’ banks as national champions that it is their duty to protect and nurture. The newly established European Banking Authority has conducted several rounds of gradually more rigorous ‘stress tests’, but the results have failed to carry confidence in the markets, largely because of the EBA’s reliance on national regulators to make a fair assessment of their ‘national’ bank positions. The remit of the EFSF/ESM has been extended to include bank recapitalisation, but uncertainties remain about the political will to pursue a course of action that will almost certainly lead to a major bank ‘shake-out’ across the Continent, involving controversial cross-border mergers and restructuring. The ECB’s decision in December to lend unlimited amounts of money to Eurozone banks at low interest rates has averted an incipient banking crisis and brought down sovereign bond yields in Italy and Spain. But it does not resolve the problem of ‘zombie banks’ with huge amounts of sovereign debt on their books. Rather, continental politicians have chosen to focus their attention on the introduction of an EU financial transactions tax. While this may be popular with electorates and a desirable measure to curb future financial market ‘excesses’, it does not address the current crisis in the European banking system.

4. **A glass half-empty as well: the dangerous politics of collective austerity**

Significant weaknesses in the proposed EU economic governance architecture remain. This chapter focuses on major deficiencies in the framework enunciated by the Commission’s communiqué and the taskforce
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These have been identified by a number of leading commentators, including the political scientist Wolfgang Streeck (Streeck, 2011) along with Andrew Watt (Watt, 2010), Senior Researcher at the ETUI in the field of economic and employment policy):

— The first is that the European Commission and the European Council are structurally disadvantaged in exercising policy discretion over Member States. This asymmetry in power resources makes it more difficult to envisage sanctions ever being imposed, particularly on the larger Member States. This casts doubt on the overall credibility of the framework.

— Second, while the proposals mark a partial shift away from the short-term focus on public sector deficits towards a focus on wider macro-economic imbalances, this is a rather limiting feature of the proposed reforms. The global crisis was caused as much by private sector debt, over-leveraged consumers, and under-capitalised banks. The continuing focus on public sector deficits is therefore inadequate, and reinforces a policy bias that the European Central Bank (ECB) must do more to correct.

— Third, the proposals may as a consequence enforce a deflationary bias, whereas the current priority in Europe ought to be growth and jobs. Targeting public sector deficits entails a continuing emphasis on austerity programmes which risks prolonged stagnation. The most profound challenge facing the EU is high unemployment, particularly youth unemployment, and low levels of growth. These ought to be a strategic priority for EU policy-makers.

— Fourth, there has been little attempt to link the new coordination arrangements with the question of financial regulation and supervision in Europe. There are separate European Commission proposals for regulating the financial sector and providing a new stability mechanism for banks. However, these are not integrated into the overall economic governance framework.

— Finally, it is not clear that policy-makers and the governing elite in Europe have grasped how urgently reforms are needed. There is a need for decisive and rapid action including a clear timetable for implementation. The risk is that the pace of institutional reform
continues to lag behind the severe pressures and shocks inflicted by the global financial crisis. The EU must send a signal to the markets that it is capable of exerting more comprehensive political and democratic control.

The remainder of this article will address each of these points in turn.

4.1 Weak European governance

Arguably the most significant tension in the proposals concerns the likelihood of overt resistance by Member States. There is as yet no real appetite in many national capitals for treaty changes that strengthen political and economic integration. There is growing resistance to the prospect of further weakening national parliamentary sovereignty, handing over power for national budgets to apparently unelected and unaccountable Brussels ‘bureaucrats’. This is already a major issue for the forthcoming (May 2012) Presidential election in France. This has been further compounded by the crisis which strengthens instincts towards national protectionism and makes retreat from the international economy more immediately attractive.

The result is that the proposed economic governance arrangements are being politically constructed on potentially unstable foundations. It remains to be seen whether the envisaged surveillance and sanctions regime will actually be applied consistently in practice. Because of her enormous economic power, Germany has huge traction in getting her way. Yet Germany’s blatant flouting of the Stability and Growth Pact (SGP) ten years ago illustrates the underlying difficulty in upholding an EU-wide system of economic governance, in that many Member States may calculate that the regime will in the last resort never be enforced.

There is also a problem of ‘over-automaticity’ on the question of deficits and debts. Watt (2010) has noted the tension between the implied goal of fiscal consolidation and the EU 2020 objectives, many of which require significantly higher levels of public expenditure. These include reducing child poverty and widening access to lifetime learning. This may not only provide a rationale for some Member States to evade the objectives of fiscal discipline. It also underlines that room for judgement is essential in any system assessing the soundness of fiscal plans.
4.2 Economic imbalances

Since the inauguration of the Maastricht Treaty, Europe has been dominated by a conservative, anti-inflation bias. In fairness, this worked reasonably well for many economies especially those in a relatively stable 'steady-state'. But for countries making massive adjustments in order to enter the euro in the late 1990s, they imposed significant economic pressures leading to markedly slower growth and higher unemployment. At the same time, there was a wider failure of macroeconomic policy in the EU. The ECB’s emphasis on inflation targeting (and fiscal rules), as in the case of the Bank of England, did not guarantee the stability that had been promised, as the events of 2008 and 2009 have only underlined. This is the legacy with which policy-makers must grapple today.

The scale and degree of macroeconomic imbalances between Member States had simply not been foreseen. Rapidly declining short-term interest rates for previously high inflation countries in the Eurozone created asset bubbles in some countries which exploded disastrously, particularly in Ireland and Spain. Private sector indebtedness rose exponentially throughout this period. The issue of macroeconomic imbalances both within Member States and across the Eurozone has to be seen in a broader context than simply the public sector current account deficit of any particular national economy.

The financial crisis was triggered by asset bubbles anchored in excessive levels of private debt, private consumption and private borrowing (Skidelsky, 2011; Gamble, 2009). In some economies such as the United Kingdom, Ireland, Portugal and Spain, the crisis revealed that those economies were too reliant on financial services and too exposed to the international banking system. At the same time, countries such as Greece, Italy and Spain experienced rapidly rising unit labour costs. Other Member States such as Germany and the Netherlands gained in competitiveness, accumulating growing surpluses. So the issue of imbalances needs to be considered within this broader policy context.

4.3 Countering the deflationary bias

The most fundamental weakness of the proposed economic governance arrangements is that they focus attention almost solely on deficit
countries, and as a result effectively impose deflationary policies. The risk is that an over-hasty enforcement of austerity programmes will drive Europe towards a decade or more of stagnation, and further relative economic decline. As has already been noted, the EU2020 goals recognise the importance of other policy imperatives such as progress in combating climate change, widening access to education and lifelong learning, and tackling poverty throughout Europe. But the objectives are too diffuse and member-state buy-in remains somewhat uncertain. There ought to be greater clarity of strategic purpose with a limited number of concrete initiatives focusing on how to reduce social disadvantage throughout the lifecycle from cradle to grave.

For much of the last two decades, ‘Social Europe’ has been negated at the expense of market liberalisation. The EU has often appeared oblivious to the social impact of economic restructuring, as well as to the imposition of the free movement of labour treaty obligations. This has led to an inevitable backlash against enlargement following the astonishing pace of Eastern European migration after 2004. It also appeared to confirm the dominance of a ‘neo-liberal mind-set’, weakening consent for further political and economic integration.

The fundamental problem in focusing only on austerity is that the broader context of European competitiveness is rather missed. The transition in economic power between East and West which has been accelerated by the global crisis poses enormous challenges, but it will not be addressed by merely seeking to out-compete the BRIC economies on labour costs. The only alternative open to Europe is the ‘high-road’ to economic growth based on creativity, quality, ingenuity and knowledge-intensive production. Investment in skills, research, science, and early years’ education needs to rise further, along with activation strategies to reduce long-term unemployment. A massive wave of cross-border infrastructure investment is needed, including an EU-wide Low Carbon Investment Bank financed by taxpayer backed euro-bonds.

Fixing the public finances of Member States requires a combination of limiting excessive borrowing today, combined with a long-term framework that can expand the productive potential of Europe’s economies, limiting the effects of the social ‘aftershocks’ that have occurred as a result of the global financial crisis. In other words, it means focusing resolutely on the need for a refocused social investment and
flexicurity strategy in Europe in order to underpin the new economic governance arrangements (Morel et al., 2011; Marlier and Natali, 2010).

4.4 Financial regulation

Strengthening the financial regulatory regime throughout the EU is essential in order to avoid the disorder that provoked the crisis in 2008-2009. This is crucial also for avoiding further imbalances. It is no longer possible to present financial liberalisation as unambiguously advantageous for European growth. While it appeared that having London as a global financial centre was beneficial for the EU, driving a wave of cross-border mergers and takeovers, there was too little focus on addressing the importance of regulation as the pace of EU financial integration quickened, exposing the inadequacies of the regulatory regime when the global crisis broke. Overall, Europe has suffered in the last two decades from a shift towards a lowest common denominator approach focused on liberalisation and deregulation. This is simply untenable for the future.

In fairness, the Commission has brought forward a far-reaching package of legislative proposals to attempt to fill the gaps, and pan-European regulatory bodies are being established for banking, insurance and securities. This will lead to a significant extension of EU competence which even the UK was largely persuaded to accept, in response to the public outpouring of anger at the behaviour of the banks prior to the financial crisis. However David Cameron’s December 2011 veto of a new EU27 treaty to establish a fiscal stability union, on the grounds that he could not achieve adequate protections for the City of London, including a rolling back of some majority voting provisions of the single market, demonstrates huge difficulties to come in achieving agreement on an essential part of a future economic stability agenda.

4.5 Radical and decisive action

The growing disenchantment with the European project has arisen in part because of the lack of bold and decisive action, despite the severity of the crisis in the Eurozone and beyond. This has to combine measures to deal with the immediate crisis, followed by institutional reforms that...
can tackle the underlying imbalances and divergences which the crisis has merely exposed. The European institutions and the political class have to demonstrate that they are capable of taking bold and decisive action. So far, there has been too little understanding of the dynamics of bond markets, and politicians’ communication with the markets has been largely ineffectual.

The crisis has also seen the return of technocratic politicians such as Lucas Papademos and Mario Monti, both of whom are highly credible figures as the market response has so far shown. The political structure underpinning both is highly volatile, however. The political class across Europe has to clearly signal to the markets that democratic political control over the European economy will be exerted and enforced at European as well as national level. Otherwise, the Eurozone will be under continuous pressure from predator forces in the international financial markets. Both short and long-term action has to be an immediate priority for European policy-makers. This means publishing a clear and detailed timetable for implementation.

**Conclusions**

These steps towards the Europeanisation of economic governance in Europe have rightly been welcomed by many leading commentators. Most of the measures ought to have been enacted some time ago, and are essential if the euro-area is to be brought back to stability and growth. The proposals can be read as an attempt to better harmonise capitalist markets with democratic politics (Streeck, 2011). However, significant weaknesses remain which need to be honestly confronted and addressed by politicians and policy-makers. The chapter has assessed the prospects for a new model of European economic governance. It argues that the framework is limited because while the proposed structure genuinely seeks to address the challenge of coordinating very different national economies, there has been too little attention paid both to financial regulation and to the need for a new growth agenda as an alternative to the politics of austerity.

A deflationary bias which eschews the social dimension in favour of austerity will not build the political consent that Europe needs to steer a rational path out of the crisis towards stability and growth. There needs
to be an effective demand stimulus for short-term recovery in Member States with room for fiscal manoeuvre (as the IMF has recommended), a medium-term focus on leveraging additional growth and jobs, and a long-term objective in shifting towards more sustainable economic models. The political acceptability of European integration will depend on a bolder approach to restoring economic growth; a renewed impetus towards socially inclusive labour market and welfare state reforms; and the espousal of a new European alternative to the now discredited Anglo-American model of capitalism. Each of these goals will in turn require bold reforms to the EU economic governance architecture. There is not a moment to lose.

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