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The (Ever) Incomplete Story of Economic and Monetary Union

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Abstract

This article applies the governance typology used in this special issue to the evolution of euro area governance. The article begins with a description of Economic and Monetary Union's original governance structure, with third order governance (shared norms) present in varying degrees in monetary, financial and fiscal governance. While a shared consensus on the importance of an independent central bank to pursue price stability allowed for the creation of the European Central Bank, euro area governance was otherwise limited to the coordination of national policies. Since the crisis, shifting norms (third order governance) allowed for the creation of new bodies (e.g. the European Stability Mechanism and the Single Supervisory Mechanism) and the expansion of the powers of existing institutions (particularly the ECB). In areas where no normative changes occurred (fiscal and economic policy coordination), second order governance has been marked by incremental changes to existing institutions. The degree to which economic governance has become more hierarchical depends both on the strength of third order governance norms and the preferences of large states like Germany either to retain their own sovereignty or create additional rules that bind member states.

Keywords

Governance; Euro area; Economic and Monetary Union; European Central Bank

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With the 1992 Maastricht Treaty, the European Union committed to the creation of Economic and Monetary Union (EMU) in three stages, culminating in the introduction of the euro on 1 January 1999. The sovereign debt crisis, however, prompted numerous reforms in economic governance (Chang, Menz and Smith 2014). The so-called Four Presidents' Report noted the need for 'a genuine economic and monetary union' to be created (Van Rompuy with Barroso, Juncker and Draghi 2012) to replace the extant system that proved to be poorly equipped to deal with the economic crisis. This official acknowledgement of the incomplete nature of monetary union was followed up by the Five Presidents' Report that explored further how to 'complete' (Juncker et al. 2015: 2) monetary union through the strengthening of democratic legitimacy, while continuing to develop and adapt the euro area's institutional architecture to the post-crisis environment.

How has EMU governance changed since its original inception and what were its primary drivers? Has there been a fundamental shift in euro area governance? Using the governance typology established by Kooiman (2003; see also Tömmel, this issue), this article examines the evolution of EMU governance in terms of its guiding norms (third-level governance) and institutionalisation (second order governance). The article begins with a description of EMU's original governance structure that was based on four pillars (monetary, financial, economic, and fiscal) (European Commission 2015a), with third order governance present in varying degrees in monetary, financial and fiscal governance. Second order governance differed substantially, as only the monetary pillar allowed for the delegation of power to a supranational institution, the European Central Bank (ECB), while financial, economic and fiscal governance were relegated to different degrees of cooperation between member states.

The article then continues by examining governance and its transformation since the crisis. Shifting norms (third order governance) have allowed for the creation of new institutions, particularly within the context of banking union and the European Stability Mechanism and the expansion of the powers of existing institutions, particularly the ECB. In areas where no normative changes occurred (fiscal and economic policy coordination), second order governance has been marked by 'layering' and 'copying' existing institutions (Verdun 2015). Indeed, in this 'fourth phase', European economic governance (Tömmel 2016) has been marked by the creation of institutions that shape member state governance, yet through modes that respect maximum national sovereignty. The degree to which economic governance has become more hierarchical depends both on the strength of third order governance norms and the preferences of large states like Germany either to retain their own sovereignty or create additional rules that bind member states.

THE ORIGINAL DESIGN OF EMU

According to Kooiman (2003), governance orders can be characterised according to levels of activity. First order governing concerns day-to-day affairs, second order governing deals with institutional arrangements that establish the framework within which first order governing takes place, and third order (or meta-) governing refers to normative governance principles that feed into the other levels of governance. How can we understand EMU in such a framework?

According to the European Commission (2015a), EMU consists of four main policy areas, particularly for the Eurozone:

- Coordination of economic policy-making between Member States
- Coordination of fiscal policies, notably through limits on government debt and deficit
- An independent monetary policy run by the European Central Bank (ECB)
- Single rules and supervision of financial Institutions within the euro area
- The single currency and the euro area.

In the monetary, fiscal and financial pillars, one can see third order governance in varying degrees, as some norms were more widely shared than others. Specifically, the stability culture permeated the monetary and fiscal pillars while the efficient markets hypothesis provides the theoretical basis for the preference for 'light touch' regulation (Quaglia 2010) in financial regulation. Second order governance in the form of the institutionalisation of these norms differed substantially, resulting in the delegation of policy to the euro area level in monetary policy but the retention of national competences in fiscal and financial policy. Economic policy lacked third order governance, resulting in minimal levels of institutionalisation.

The dominant norm in the euro area is that of the stability culture, which refers to the importance of price stability and fiscal rectitude to the economy. Germany was the primary advocate of the stability culture, though some of its ideas were widely shared. Ideas on the importance of price stability and the success of independent central banks in achieving it led to the delegation of monetary policymaking to, first, the German Bundesbank in the European Monetary System, and then the ECB (Dyson 2000). Moreover, an independent central bank was an indispensable part of monetary union for Germany (Loedel 1999).

The remaining pillars of EMU did not involve a similar transfer of power to the supranational level or the creation of powerful new institutions. Instead, the EU sought to reconcile European policy goals with those of national governments, including disagreements among the latter (Tömmel 2016). On the fiscal side, the Maastricht Treaty says very little beyond the convergence criteria on debt and

deficits. This would later get fleshed out in the Stability and Growth Pact (SGP), in which member states would continue to adhere to the deficit criterion in the Maastricht Treaty to ensure long-term fiscal rectitude (Heipertz and Verdun 2010). While this norm (part of the stability culture) constituted a third order form of governance, its second order institutionalism was limited to a rules-based regime rather than the creation of independent institutions; no normative consensus existed that would justify a more hierarchical governance structure at this time. Indeed, the fiscal ideas related to the stability culture were not widespread like the ideas relating to price stability and central bank independence. Germany was the main advocate of the SGP, reflecting the intergovernmental nature of the institutional configuration of monetary union (Heipertz and Verdun 2010).

The Maastricht Treaty also featured what became known as the 'no bailout clause' (now Article 125 TFEU) that made it illegal for one member state to assume the debts of another. Despite sharing a single currency, the Maastricht Treaty did not allow for a shared fiscal capacity. The assumption was that if all the member states duly followed the rules and kept deficits low, there would be no need to come to the rescue of another member state. The sovereign debt crisis quickly revealed the inadequacy of this rules-based system. The third pillar is the financial pillar. Prior to the financial and debt crises, member states retained authority for financial supervision under the Lamfalussy process, which provided a framework for EU-level financial regulation with the input of national regulators and supervisors. Although cross-border banking increased after the introduction of the euro, supervision remained national and regulation only 'light touch' (Quaglia 2010) due to the prevailing norms established by the efficient markets hypothesis (Fama 1970). As with the monetary pillar, the EU can be seen as engaging in meta-governance processes in its dissemination of norms advocating such 'light touch' regulation. Unlike monetary policy, this did not lead to more hierarchical governance in this area but second order governance in the form of directives and regulations created through the Lamfalussy process (Quaglia 2010), with no centralised supervision. Instead, a 'battle of the systems' (Story and Walter 1997) arose with member states using different types of institutions to supervise domestic financial systems. For example, some used national central banks as supervisors, others used separate financial supervisors, and sometimes financial supervision was divided between multiple institutions.

The economic pillar was based on even looser cooperation between member states than the fiscal pillar, with no overarching norms to guide governance at a meta level. Economic policy cooperation refers to a wide range of economic activity, including but not limited to pensions, labour markets, health care systems, taxation, wage developments and market liberalisation. Whereas the fiscal pillar was based on hard law and had the possibility (albeit never used) of sanctioning member states that broke the SGP rules, the economic pillar had no such measures. The Maastricht Treaty made economic policies a 'matter of common concern' (Article 103 TEC), with the Lisbon Strategy in 2000 (renewed in 2005) and currently the Europe 2020 Strategy (replacing the Lisbon Strategy in 2010) setting targets for member states covering employment, research and development, climate change/energy, education, social inclusion and poverty reduction in order to 'create conditions for smart, sustainable and inclusive growth' (European Commission 2015b). Nevertheless, this pillar remains as the coordination of national economic policies under 'soft law' (Hodson and Maher 2001).

Institutionally, EMU's main actors included the European Central Bank, the Ecofin Council, and the European Commission (DG ECFIN and DG MARKT). First, the European Central Bank formed monetary policy for the euro area as a whole. Despite the ECB's independence, its capacity to act as a central bank akin to that of the Federal Reserve or the Bank of England was limited. Specifically, the ECB did not have the power to act as the lender of last resort, a typical function for a national central bank. Article 101 TEC (now Article 123 TFEU) prohibits monetary financing, meaning the overdraft facilities, credit facilities, or direct purchase of debt instruments from EU institutions,

bodies, offices or agencies as well as central governments, regional, local or other public authorities and other bodies governed by public law (Buiter and Rahbari 2012). These prohibitions stem from the aforementioned ideas regarding the importance of price stability, which would be threatened by such monetary financing. Moreover, some member states, particularly Germany, refused to consider establishing a fiscal union or a political union which implies shared responsibility for other member state liabilities (Heipertz and Verdun 2010). Second, the Commission (DG ECFIN) performed economic and fiscal surveillance and drafted recommendations regarding member state adherence to Stability and Growth Pact rules as well as Broad Economic Policy Guidelines, which would then be confirmed (or not) through a qualified majority vote by Ecofin. Finally, DG MARKT initiated financial regulation that was passed by Ecofin (with the participation of the European Parliament).

In addition to these institutions, two others are worth noting. First, the Ecofin Council also met in another formation, that of the Eurogroup (finance ministers of the member states participating in EMU) that met prior to Ecofin meetings. The Eurogroup was created from a compromise between France's interest in a more accountable central bank and Germany's defence of the ECB's independence. While a consensus had emerged regarding the utility of central bank independence and the importance of price stability for the economy, not all member states had a history of independent national central banks; instead, central banks in countries like France and Italy took orders from the Treasury (Goodman 1992). While such banks did not enjoy the same success as their independent counterparts in achieving price stability, they did have the advantage of democratic accountability. The French government thus proposed an 'economic counterweight' to the European Central Bank, or a *gouvernement économique* that posed 'an explicit challenge to the ECB's goals and goal-setting and operational independence' (Howarth 2007: 1062). Predictably such a proposal aroused German opposition, given its potential threat to the future central bank's independence. The compromise was what would become the Eurogroup, which would conduct informal meetings but lacked both decision-making authority and a legal personality. Nevertheless, the Eurogroup became an important forum for the exchange of ideas between the finance ministers of euro area countries. Eurogroup meetings provided participants with the opportunity to enjoy a frank exchange of views and to 'pre-cook' the Ecofin meetings in which decisions would be taken (Puetter 2006). Over time, the Eurogroup would also become more institutionalised, though this would not necessarily make it more effective (Hodson 2011).

Second, the European Parliament played a limited role in legislation in this area. Although it conducts hearings with the ECB that are akin to the hearings held by the US Federal Reserve before Congress, the European Parliament holds no authority over the ECB and cannot force compliance with any of its recommendations, whereas theoretically Congress could revoke the independence of the Federal Reserve. Although the latter is an extreme and unlikely occurrence, it does underline the respective degrees of accountability of the Federal Reserve to Congress versus the ECB's accountability to the European Parliament. Nevertheless, these hearings allowed the European Parliament to boost its profile and the ECB to claim greater accountability and transparency (Chang 2002). Parliament's role in financial regulation was restrained until the passage of the Lisbon Treaty in 2009 gave it co-decision power, placing it on equal footing with Ecofin. Since then, the EP has a mixed record in the expansion of its powers (Rittberger 2014).

There were serious concerns about the ability of European states to cope with a single currency given their economic diversity. The solution was to make entry into Economic and Monetary Union conditional on achieving the Maastricht Treaty convergence criteria: exchange rate stability;[1] interest rate convergence;[2] inflation rate convergence;[3] 3 per cent deficit limit; and 60 per cent public debt limit. These criteria reflected German concerns over fiscal sustainability and macroeconomic stability, as per the stability culture. However, not all countries decided to join EMU. Two states, Denmark and the UK, obtained opt-outs from monetary union. In addition, Sweden refrained from joining by deliberately not meeting the criterion on exchange rate stability (by not

entering its currency into the successor to the European Monetary System). After the Maastricht Treaty, however, no more opt-outs for monetary union were given and all subsequent EU member states were expected to adopt (eventually) the euro as their currency.

The original economic governance system for EMU did not incorporate the insights from optimum currency area theory (Mundell 1961), particularly the need for a way to deal with asymmetric shocks. The 1990 Commission study had dismissed optimum currency area theory as 'too narrow and somewhat outdated' (European Commission 1990: 31). The euro area lacked the fiscal capacity and labour mobility advocated by optimum currency area theory (Bayoumi and Eichengreen 1993). This can be attributed to a combination of economic norms (third order governance) along with intergovernmental preferences (i.e. German) that resulted in hierarchical governance when it came to monetary union but was limited to fiscal, economic and financial cooperation of national policies. The original governance of EMU therefore mixed hierarchical (ECB) with non-hierarchical (fiscal policy, economic policy, financial supervision) governance (Verdun 2009). This varied configuration was the only way that member states would allow such policy discussions in the EU, as they were reluctant to lose even more policy levers after losing monetary policy and the ability to devalue their national currency under EMU.

THE NEW ECONOMIC GOVERNANCE OF THE EURO AREA

The onset of the global financial crisis and the subsequent sovereign debt crisis exposed the deficiencies in these earlier ideas. Although often accused of doing too little, too late, the EU did respond with a comprehensive set of governance reforms that at least partially addressed the weaknesses of the original governance system. These weaknesses included an overreliance on rules (Pisani-Ferry 2010); a lack of financial supervision (Eichengreen 2012); and a lack of fiscal capacity giving the EU the power to tax and spend (De Grauwe 2006) or deal with crises (Verdun 2015). Such institutional weaknesses were compounded by a series of false assumptions regarding the operations of markets and the evolution of EMU.

False assumptions behind EMU

The first fallacy was the assumption that monetary policy dedicated solely (or mostly) to price stability was sufficient and that price bubbles (like real estate bubbles or other asset bubbles) should be pricked after the fact (Mishkin 2007). Real estate prices boomed in certain areas of the USA as well as in Europe, egged on by low interest rates in both regions. Central banks could have helped stem the burgeoning crisis by raising interest rates earlier than 2004. As explained by Roubini (2006: 87):

> bubbles may lead to economic distortions as well as financial and real economic instability … optimal monetary policy requires monetary policy authorities to react to such bubbles over and above the effects that such bubbles have on current output growth, aggregate spending and expected inflation.

Second, the assumption of efficient markets, based on the efficient market hypothesis (Fama 1970), provided the rationale for the 'light touch' financial regulation that proliferated in the previous decade. Investors did not behave as rationally as presumed and seriously underpriced risk in the case of the subprime mortgage loans and the collateralised debt obligations that were based on them. Moreover, despite the explosion of cross-border banking in Europe, supervision remained at the national level rather than granting the EU stronger powers (Quaglia 2010). The De Larosière report (2009), written by a high-level working group tasked by the European Commission to investigate the causes of the global financial crisis, concluded that the lack of macro-prudential

supervision was a major cause of the crisis and recommended that 'an Institution at EU level be entrusted with this task' (De Larosiere 2009: 39). This false assumption of quasi-self-regulating efficient markets had contributed to government complacency with national-level supervision despite the important growth of cross-border finance.

Another false assumption on the part of the EU was that EMU would lead to economic convergence. According to the European Commission's 'One Market, One Money' study (1990), EMU was expected to promote convergence and reduce regional disparities. Instead, economies diverged once the pressure of meeting the Maastricht Treaty criteria was removed. Moreover, reform fatigue in the aftermath of achieving EMU membership made member states less inclined to undertake further structural reforms. Considering their easy access to financing thanks to the low interest rates all euro area countries obtained, this was perhaps understandable. This lack of economic convergence was recognised by the European Commission (2008) even before the onset of the crisis, though it was not clear how this would eventually impact the euro area just one year later. Indeed, despite the no bailout clause and the prohibition of monetary financing by the ECB, investors assumed that the EU/euro area would surely come to the rescue of one of their own if circumstances demanded it. This led to an underpricing of risk as investors failed to account for differences in economic conditions between euro area countries (De Grauwe and Ji 2013; Ghosh, Ostry and Qureshi 2013). When Greece's troubles mounted in late 2009 and 2010, investors were forced to disavow such notions, leading to the creation of the (temporary) bailout mechanism of the European Financial Stability Facility (EFSF) and eventually the European Stability Mechanism (ESM).

How did the EU reform its system of economic governance? Slowly and under threat. The EU's response to the global financial crisis and sovereign debt crisis required a flurry of emergency summits that repeatedly claimed that a comprehensive solution had been reached, only to require additional measures shortly thereafter (Smeets and Zimmerman 2013). The initial response to the global financial crisis brought about an incremental adjustment regarding financial regulation, establishing the European System of Financial Supervision (ESFS). This entailed the upgrading of the existing Lamfalussy committees to 'authorities', e.g. the Committee of European Banking Supervisors became the European Banking Authority, the Committee of European Securities Regulators became the European Securities and Markets Authority, and the Committee of European Insurance and Occupational Pensions Supervisors became the European Insurance and Occupational Pensions Authority. In addition, a new institution was created, the European Systemic Risk Board, to look for systemic risks to the European financial system. While these changes were a step in the right direction, they were a rather tepid response considering the magnitude of the global financial crisis that preceded it. Indeed, one of the most important recommendations from the De Larosière Report was the creation of European-level financial supervision. Nevertheless, strong political pressure kept banking supervision in the hands of national authorities (Quaglia 2010). The new European System of Financial Supervision did nothing to change this.

REFORMING EMU: THIRD ORDER GOVERNANCE CHANGES

As the sovereign debt crisis wore on, each of the aforementioned pillars of EMU experienced reform. Both third order and second order changes can be identified as norms shifted in some areas (especially crisis management and financial supervision) and in other cases evolved more gradually and concerned only second order institutional adjustments. On the one hand, one can see considerable continuity in that German preferences (based on ideas from the stability culture) strongly influenced the pace and content of the reforms. On the other hand, the ECB also emerged as an indispensable actor in euro area governance.

As set out above, the EU created a temporary bailout fund (European Financial Stability Facility), followed by the permanent bailout fund, the European Stability Mechanism (ESM) (Gocaj and Meunier 2013). The European Court of Justice has ruled that the ESM is not incompatible with Article 125 TFEU (the no bailout clause), as the funds in the ESM are only disbursed if a country abides by a conditionality programme akin to those traditionally required of countries receiving IMF support (the IMF was a partner in the euro area bailouts from 2010-2014 as part of the troika) (European Court of Justice 2012). This involved a normative shift away from the original governance structure that assumed that crises and fiscal transfers could be kept at bay by adhering to rules (like the convergence criteria and SGP), thereby constituting a third order governance shift.

Second, third order governance changes also can be seen in the expansion of the influence of the European Central Bank. The ECB attained greater prominence during the crisis for its use of non-standard monetary policy and its role as a key interlocutor of governments undergoing structural reform, both bilaterally and as a member of the troika. During the crisis, the European Central Bank emerged as a quasi-lender of last resort (Buiter and Rahbari 2012; Hu 2014; Micossi 2015). While central banks like the Federal Reserve and the Bank of England already enjoyed such legal authority, this was explicitly denied the ECB due to the fiscal and political implications of such a move. Nevertheless, in an effort to prevent the implosion of the euro in the face of the inaction of member state governments, the ECB embarked on non-conventional monetary policy like the Securities Market Programme (SMP) (purchasing government debt in limited amounts on secondary markets), the Long-Term Refinancing Operations (LTROs) (which provide cheap liquidity to banks), the Outright Monetary Transactions (OMT) (purchasing government debt in unlimited amounts on secondary markets in exchange for an ESM bailout, though the OMT has never been used), and quantitative easing (Micossi 2015). The ECB has justified these measures on the need to repair the monetary transmission mechanism, as the financial fragmentation in the euro area meant that the ECB's standard monetary policy was not influencing investors sufficiently. The non-standard measures were controversial in that they arguably had fiscal and political implications, particularly if the plans went awry and the ECB suddenly found itself with bad assets on its balance sheets. Others feared that the ECB's policy would engender moral hazard, allowing governments to ease up structural reforms once the ECB's actions reduced market pressure. Moreover, there were political ramifications, as ECB action came at the price of concomitant member state actions to buttress economic governance (Yiangou, O'Keeffe and Glöckler 2013).

In addition, the ECB's advisory role towards governments became much more prominent (Salines, Glöckler and Truchlewski 2012). This took place both through bilateral communications between the ECB and government leaders and through the ECB's participation in the troika. Then-ECB President Jean-Claude Trichet wrote to the Irish Finance Minister in November 2010 on behalf of the ECB Governing Council, urging Ireland to agree to an adjustment programme or risk having its Emergency Liquidity Assistance (in which the national central bank provides exceptional funding to solvent financial institutions) cut off (European Central Bank 2010). Similar letters were addressed to Italy and Spain (Draghi and Trichet 2011) in 2011, in which the ECB President (first Trichet and then his successor Mario Draghi in the letter to Italy) urged the respective governments to undertake structural reforms and improve public finances. The implication was that without such actions, the ECB would cease its support of these countries' bond markets in its SMP. While the ECB clearly had a stake in the continued viability of these economies and their public finances, particularly given that its balance sheet was expanding with their sovereign debt, it is difficult to maintain the fiction of the ECB as strictly a technocratic actor rather than a political one (though this advisory role was foreseen in Treaty Article 127.4 TFEU - see Salines, Glöckler and Truchlewski 2012). The ECB has thus been called a 'strategic actor' (Henning 2016) and a 'policy entrepreneur' (De Rynck 2015), underlining its more politicised role.

Finally, the ECB participates in the troika along with the IMF and the European Commission. They are in charge of the surveillance and implementation of financial assistance programmes of countries receiving official aid from first the EFSF and now the ESM. The ECB's involvement in the troika has raised questions of a possible conflict of interest (Pisani-Ferry, Sapir and Wolff 2013; Sapir, Wolff, De Sousa and Terzi 2014). First, the ECB's role in the troika could diverge from its interest in maintaining price stability. For example, it could relax its pursuit of price stability in order to ease pressure on a country under a bailout programme. Second, being in the troika could influence the ECB's liquidity policy. For example, the ECB could be overly generous with its provision of liquidity in the interest of the programme country's success. Finally, the ECB's purchases of sovereign debt have made it an important creditor, which could make it too stringent on the level of budgetary consolidation during programme negotiations.

The expanded role of the ECB constitutes another example of a third order shift in EMU governance. Rather than a technocratic actor concerned with price stability, the ECB is actively involved in political decisions that have redistributive consequences (Torres 2013). Moreover, the ECB's efforts to 'do whatever it takes' (Draghi 2012) to save the euro through non-standard measures also indicates an internal normative evolution that was brought about by the crisis.

Another third order shift in norms can be seen in the creation of the banking union. In June 2012, the euro area committed to the creation of a banking union, starting with the designation of the ECB as the Single Supervisory Mechanism. In 2014, the ECB assumed the direct supervision of about 130 of the largest banks in the EU, working with the European System of Financial Supervision, particularly the European Banking Authority (EBA). The EBA retains its role of implementing a single rulebook (consisting of directives and regulations from the Commission) and encouraging supervisory convergence across the EU. Therefore, while the ECB would be directly responsible for large banks, it would still have to work with national supervisors that retained authority over the rest of the banking system. This stipulation stemmed from German concerns over its regional banks that would not fare well under centralised supervision, having enjoyed preferential consideration from regional governments and national bank supervision (Howarth and Quaglia 2013). In 2013, banking union was buttressed with the Single Resolution Mechanism for winding down banks in difficulty. This would be decided by a Single Resolution Board comprised of representatives from the ECB, the Commission and national authorities. A pan-European deposit guarantee, which numerous economists argue is an essential element of banking union (Enderlein et al. 2012), did not occur due to concerns that some countries (like Germany) would be perennial net contributors to such a scheme (Howarth and Quaglia 2013). Though an EU directive on common deposit schemes exists, there is no mutualisation. Nevertheless, banking union constitutes the most significant governance change to EMU since the introduction of the euro. The delegation of authority over an area as economically significant and politically sensitive as finance indicates a shift in favour of ideas that view a single currency and financial stability as being incompatible with national supervision (Schoenmaker 2011) given the interdependence of sovereigns with their banks (Pisani-Ferry 2012).

REFORMING EMU: SECOND ORDER GOVERNANCE CHANGES

Reforms to the pillars of fiscal and economic policy were limited to second order shifts. The pillar of fiscal cooperation was strengthened considerably, but in a very specific way. Fiscal integration did not imply the large-scale pooling of resources. Instead it involved strengthening the existing predilection for controlling national budgets. First, the Stability and Growth Pact was strengthened as part of the 'six-pack' legislative package on economic governance that went into force in 2011. The original narrative of the sovereign debt crisis emphasised fiscal laxity because the original country to come under threat (Greece) had a long history of excessive public spending. This is despite the fact that some of the other countries (Ireland and Spain) that were labeled as 'PIIGS'

(Portugal, Italy, Ireland, Greece, and Spain) had abided by the SGP prior to the global financial crisis reaching Europe in 2008. Therefore, in 2010 both the European Commission and the Van Rompuy Task Force advocated stronger fiscal rules that would entail greater automaticity so as to avoid another incident such as occurred in 2003 when the SGP rules were suspended due to political motivations (Chang 2006; 2013). In addition, the six-pack put debt on equal footing with deficits, defined an 'expenditure benchmark' as part of each country's medium-term budgetary objective, and introduced a macroeconomic imbalances procedure (Savage and Verdun 2016).

The march towards more fiscal consolidation in Europe continued in late 2011, when the idea of a 'fiscal compact' was introduced by Mario Draghi at a hearing with the European Parliament. The fiscal compact set additional budgetary rules that were to be implemented in national law and monitored at the national level by independent institutions; non-compliance could result in financial sanctions. In the context of market speculation against the sovereign bonds of euro area countries in the periphery, it would play a role in calming market expectations in two ways. First, it would be 'the most important element to start restoring credibility' (Draghi 2011). Second, it was essentially a quid pro quo for action on the part of the ECB: if the governments committed to such a fiscal compact, the ECB would respond with LTROs (Yiangou et el. 2013). Thus the fiscal compact became part of the Treaty on Stability, Coordination and Governance (TSCG) that was signed on 2 March 2012. Originally, the TSCG was supposed to be part of a revision of the Lisbon Treaty, but British opposition led to a separate treaty from which EU member states could opt out. Both the Czech Republic and the UK declined to sign the TSCG, which included not only the fiscal compact but measures to strengthen euro area governance like the creation of regular summits (Hodson and Maher 2014).

The EU further reinforced its budgetary surveillance with the entry into force of the two-pack legislative package in May 2013 (Savage and Verdun 2016). This introduces a common budgetary timeline and allows the Commission additional opportunities to examine national budgets. If the Commission deems that a country's budget does not comply with SGP obligations, the member state will be asked to submit a revised plan. For countries experiencing financial difficulty, EU-level control is strengthened further. Certain elements of the fiscal compact were integrated into EU law through the two-pack, such as the preparation of economic partnership programmes by countries that break the SGP and the mandatory ex-ante coordination of debt issuance by member states. The reinforcement of the economic pillar comes largely from its rationalisation, with previous efforts to link policy surveillance with fiscal surveillance as part of the March 2005 reforms of the Stability and Growth Pact and the Lisbon Strategy continuing with the creation of the European Semester in 2011. This is an annual policy cycle, in which the European Commission considers the fiscal and structural reform policies of EU member states, offers recommendations, and provides surveillance of the implementation of commonly agreed policies. As noted by Marzinotto, Wolff and Hallerberg (2011), the European Semester contains two procedural innovations: national governments must submit their Stability (for euro area countries) or Convergence (for non euro area countries) programmes on budgetary policies, in compliance with the SGP, prior to their discussion by national parliaments to improve economic policy coordination; and member states submit their Stability or Convergence Programmes at the same time as their National Reform Programmes on economic policies, in compliance with the Europe 2020 strategy, to account better for any complementarities and spillover effects.

In addition, economic policy coordination plays a role in the new Macroeconomic Imbalances Procedure, which is a macroeconomic surveillance procedure to avoid economic bubbles. It appears to contain a deflationary bias in that deficit countries tend to find themselves under pressure of the procedure but not surplus countries (De Grauwe 2012; Gros 2012; Gros and Busse 2013), indicating normative continuity with the aforementioned stability culture. Hence, this constitutes only a second order governance change and not a third. While the EU's efforts in fiscal and economic policy governance have been multi-pronged, they do not represent a normative shift. They reinforce the

existing preference for budgetary stability, thus constituting incremental changes to second order governing. Similarly, the reforms related to economic policy coordination tended to reinforce existing institutions and instruments rather than upend them (Verdun 2015). As with the pre-crisis governance system, their structure and content was largely determined by German preferences that are outlined in the stability culture.

CONCLUSION: THE NEW EURO AREA GOVERNANCE

The economic governance of the euro area has seen incremental changes to second order governance as well as third order changes in norms and economic ideas. As discussed above, fiscal governance reforms were limited to second order changes in the sense that they strengthened the existing SGP. Similarly, the economic governance reforms show continuity in both form and substance, with the Europe 2020 strategy trying to improve economic growth and competitiveness (as with its predecessor, the Lisbon Strategy) and institutionally still relying on the use of soft law. Even in these areas, however, we can see more diversity in economic governance structures. As Verdun (2015) argues, while some new institutions (like the six-pack and two-pack) fit within the normal procedures of the EU, others (like the fiscal compact) 'copied' the intergovernmental structure of agreements like the Schengen agreement on free movement. This created a new type of institutional structure for fiscal and economic policymaking in addition to the use of Community (hard) law in the case of fiscal policy cooperation and soft law in the case of economic policy cooperation.

The largest changes came in the fields of monetary policy and financial policy regulation where third order governance changes took place. In monetary policy, the EU has assumed the role of quasi-lender of last resort, increased its political profile as advisor of national governments in economic and financial policy, and has become the supervisor of the euro area banking system. In the case of financial policy regulation, the initial crisis response can be seen as incremental, perhaps demonstrating a path-dependent logic (Salines, Glöckler and Truchlewski 2012). The sovereign debt crisis and threat of the euro area's implosion prompted stronger reforms that resulted in banking union, indicating a third order shift on issues like financial regulation and supervision.

What conclusions can we draw from euro area governance reforms more generally? The first is that the European Central Bank constitutes a rising power. It transformed from a largely technocratic body with a very specific function to one of the major political actors in the European Union. While this rise can partially be explained by the leadership vacuum in the EU, one must also consider the ECB's role as a policy entrepreneur (Chang 2014; De Rynck 2015; Henning 2016). The crisis presented a strong challenge to existing ideas of euro area governance, including the adequacy of a central bank focused solely on price stability. Moreover, the mandate of the ECB has expanded to include banking supervision as well as overseeing structural reform as a troika member.

Second, Germany has cemented its position as the euro area's leader. While Germany's significance in economic governance since well before EMU is undeniable, the crisis made it even more apparent. First, France's traditional role as Germany's partner became less pronounced as French President Hollande sought alternative political allies (Schild 2013), leaving the preferences of Germany and its fellow creditor countries as the primary drivers of policy. Nevertheless, Germany's traditional pro-European stance sits uneasily with the policies it has pursued during the crisis, particularly its reluctance to mutualise any debt. The bulk of the assistance given during the sovereign debt crisis must eventually be repaid, and more innovative ideas like Eurobonds have been rejected. Germany has therefore been a reluctant hegemon (Bulmer and Paterson 2013), constrained by domestic political concerns (Bulmer 2014).

Finally, euro area governance became increasingly hierarchical in numerous respects, especially in regard to surveillance. Banking union has centralised banking supervision, particularly for the largest banks (Howarth and Quaglia 2013). Fiscal policy reforms have increased the surveillance capacity of the European Commission, even allowing it to interfere in member state budgets in certain situations (Savage and Verdun 2016). For countries experiencing financial difficulty, demands from its EU partners can become onerous indeed.

For all the criticism that the euro area has done too little, too late, by the standards of European integration these governance reforms moved at lightning speed. Only under severe market pressure could the euro area governments overcome their differences (such as in the creation of the ESM or banking union) or allow another actor to step in and buy time, thereby increasing its own power in the process (e.g. the ECB). While these reforms may still be far from ideal, they do represent an overall strengthening of the economic governance framework.

The state of EMU remains 'incomplete', both theoretically and institutionally. Theoretically, debates continue to rage regarding the need for a more robust banking union and a greater fiscal capacity or fiscal union. Institutionally, the Five Presidents' Report (Juncker et al. 2015) outlined plans for the deepening of EMU in ways that would strengthen convergence, competitiveness and democratic legitimacy. In the absence of third level ideational shifts in governance, the EU's ability to achieve 'a complete economic and monetary union' (Juncker et al. 2015: 20) is uncertain.

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[1] Normal fluctuation margins provided for by the exchange rate mechanism of the ERM 2, for at least two years, without devaluing against the euro.

[2] Average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing member states in terms of price stability

[3] A rate of inflation which is close to that of, at most, the three best performing member states in terms of price stability.

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