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Economic Papers 311 | March 2008

Economic governance in an enlarged euro area

Iain Begg

Economic and Financial Affairs
DIRECTORATE-GENERAL

EUROPEAN COMMISSION

EMU@10 Research

In May 2008, it will be ten years since the final decision to move to the third and final stage of Economic and Monetary Union (EMU), and the decision on which countries would be the first to introduce the euro. To mark this anniversary, the Commission is undertaking a strategic review of EMU. This paper constitutes part of the research that was either conducted or financed by the Commission as source material for the review.

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ISBN 978-92-79-08236-8
doi: 10.2765/50808

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Economic governance in an enlarged euro area

Iain Begg[1]

European Institute, London School of Economic and Political Science

Abstract:

Ten years on from its launch, it is clear that EMU, which has to be regarded as a more profound regime change than is often acknowledged, has had a pronounced effect on economic governance. As a framework for the conduct of macroeconomic policy, EMU has had undoubted successes in assuring price stability and in instilling greater fiscal discipline, yet it is open to the criticism that it has not (yet?) delivered improved performance in the real economy. Moreover, some of the compromises made at the outset and over the twenty years since the roadmap for EMU was first set out, notably to reconcile divergent French and German preferences, have left certain elements of the policy architecture unresolved. In the coming years, several more Member States are expected to become full participants in EMU, so that fresh thinking on the governance arrangements is warranted, not least to accommodate the rather different economic characteristics of the candidate countries.

This essay looks at the governance of EMU and how it may need to evolve as the euro area enlarges. It discusses the meaning of economic governance and puts forward a conceptual model embracing different facets of governance, highlighting the significance of policy co-ordination, then assesses how well EMU fares on these aspects of governance. The essay then discusses the challenges of fulfilling the convergence criteria for prospective new members of the euro area and suggests possible changes in the application of the criteria, and considers how the institutional structures for managing EMU may need to evolve. The need for greater politicisation of economic decision-making and for new approaches to policy co-ordination – especially to integrate the supply-side more effectively - is stressed as a likely way forward if EMU is deal with emerging demands on policy-making

Key words: euro area enlargement, governance, economic policy co-ordination, EMU

JEL classification: E62, F42

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[1] I am grateful to Joost Kuhlmann and Jean Pisani-Ferry for constructive comments on earlier drafts. They are, naturally, absolved from any blame for remaining infelicities.

1 Background and issues

EMU has to be understood and analysed as a profound regime change, even though it is a change that has been implemented via incremental steps and which does not have a clear *finalité*. A corollary is that the present arrangements for economic governance cannot be regarded as stable. Further evolution of the system may encompass a substantial increase in the number of members of the euro area, the degree of engagement of the EU level in policy formulation and implementation, and the balance between the 'economic' and the 'monetary' in EMU. This characterisation of EMU as a system in flux, in turn, has far-reaching implications for the 'demand' for governance, as well as how it is 'supplied'.

EMU has undeniably assured a high degree of price stability and, in this regard has made a striking difference to previously inflation prone Member States. However, despite the widespread support for EMU, the performance of the real economy of the euro area over the last decade has been disappointing, particularly during the slow recovery from the 2001 recession in the core EU Member States. There is also evidence that imbalances within the euro area have been growing, and that there has been no great convergence of economic cycles, as might have been expected, coupled with divergent trends in competitiveness. What these trends hint at is that the euro area is not (yet?) becoming more optimal than it was ten years ago as a currency area. Even so, suggestions that EMU is vulnerable are far-fetched and Eichengreen (2007) offers a well-argued account of why a break-up of EMU is highly unlikely.

From a governance perspective, it is important to stress how much has gone to plan and to reflect on how silly some of the apocalyptic views of what would happen when the single currency was launched – heard far more from across the Atlantic than from Europe - now look. Monetary policy, in particular, has functioned effectively, while the introduction of notes and coins was achieved with a remarkable lack of disruption. The other elements of the institutional structure have, in addition, performed their roles broadly as intended, if with evident tensions on occasion. There are nevertheless critics of the institutional setup and calls for new developments. De Grauwe (2006: 23) makes the forceful point that there is an asymmetry in the conjunction of responsibilities for economic policies and accountability for them. National policy-makers are held to account for negative outcomes such as higher unemployment over which they have limited direct scope for policy action, but the power lies with European institutions which 'bear no political responsibility for their decisions'. Yet the traffic need not all be one way, as national policy-makers can be expected to claim the credit for positive outcomes.

Ten years on from the launch of the euro, therefore, it is timely to ask whether the governance structures put in place in the early 1990s and refined since are suited to the demands of a euro area that before long will have doubled its membership. Enlargement of the euro area will pose additional challenges by greatly widening the range of economic conditions that have to be accommodated by a single monetary policy. Awkward questions also arise, for example, about whether soft means of governance will become more problematic and whether the Eurogroup, as presently constituted, with its informality and lack of formal executive capability, can fulfil an effective governance role. As the euro area enlarges calls for some form of European economic government can be expected, although the form remains to be clarified. These and many other debates around how to govern EMU are far from resolved.

1.1 EMU economic governance, performance and transformations

Since the extensive reforms in 2005 and 2006 of the different components of economic governance, a new architecture of economic policy-making has emerged in the EU, embracing structural policies as well as the demand side. These reforms comprised the revisions to the Stability and Growth Pact (SGP), the re-launch of the Lisbon Strategy and the settlement of the EU budget for the period 2007-13, as well as re-cast sustainable development and social policy strategies. These changes have manifestly built on the policy framework put in place by the Treaty on European Union as it evolved from Maastricht to

Nice, which provided a clear policy structure for the governance of monetary union, rooted in a stability-orientated approach to macroeconomic policy. More weight is now accorded to policy co-ordination under the Lisbon strategy. Within reason, ‘Lisbon re-launched’ is the big umbrella under which all the other economic governance processes now shelter and is manifestly also the core political project of the current Commission. Another intriguing feature of the emerging system is the growing degree of process integration, with connections of various sorts between different strands of economic governance.

Although the headline data for the last decade are not very encouraging about the ‘performance’ of EMU in terms of growth or unemployment (for a more detailed presentation, see Pisani-Ferry et al., 2008), it has to be recognised that it has had, and continues to have, a transformative effect on economic structures. Certainly, as was stressed by Commissioner Almunia (2007) in his address to the Brussels economic forum, the stability that has come from EMU has radically altered the economic environment by bringing in not just low inflation but also low interest rates. For some euro area members, these changes have resulted in large windfall gains. In addition, significant fiscal ‘consolidation’ took place during the 1990s, notably while Member States sought to qualify for stage 3 of EMU. However, after the launch of EMU, the larger countries, especially, did not consolidate their public finances sufficiently to attain the position of ‘close to balance or in surplus’ at the heart of the SGP. Then, as the slowdown became more prolonged than was generally forecast, the French and German deficits breached the 3% limit, triggering the excessive deficit procedure (EDP). Concerns have also surfaced in some Member States about the strength of the euro.

The transformations wrought by the euro have nevertheless fed into the dynamics of European integration. Mongelli and Vega (2006) in summing up the evidence on the effects of the euro on its member economies come to a number of conclusions:

- Trade intensity has increased for euro area members
- Financial integration has accelerated and, probably, has been more to the benefit of larger than smaller members, but also shows signs of contributing to risk pooling
- Structural reform was reasonably rapid during the run up to the start of the euro, but has been slower since in the larger countries of the euro area
- There is a high degree of business cycle synchronisation, but it has not increased and there has been no change in the divergence of growth rates

However, although the progress of EMU has been considerable, there is also a concern, succinctly put by Martin Wolf in his comment on Wyplosz (2006). ‘What am I saying here? It is quite simple: great monetary union, pity about the economy – that just doesn’t make sense to me’.

1.2 Uncomfortable bed-fellows

Although EMU appears to have a solid constitutional and institutional basis, there is continuing controversy about some of its key features. Indeed, political and policy cleavages that have had a significant bearing on how the governance of the euro area developed have long characterised the EMU project. There have been many strands to these debates, with differing camps such as the ‘economists’ versus the ‘monetarists’ standpoints in determining how to engineer the transition to the single currency, and presumed disjunctions between the interests of core and periphery, or of large and small members. Other debates have concerned the need for a centralised fiscal stabilisation capacity (included in the Werner blueprint for EMU, but discarded by the late 1980s), the case for more explicit co-ordination mechanisms or the necessity of an economic counterpart to the powerful, centralised monetary authority. For some, the notion of the ECB on a pedestal at the heart of the governance system is seen as regrettable.

Although the forms of governance that are in place typically owe more to one side than the other, there are many facets of EMU that continue to be uneasy compromises. Thus, it was the

'economists' who won the argument about the transition to the single currency, notably through the imposition of nominal convergence criteria, rather than seeking an optimal combination according to optimal currency area principles. But as Wyplosz (2006) argues, it may have been an incomplete victory insofar as the 'monetarist' view prevailed in the implementation of the rules, with many countries acceding in the first wave, despite not fulfilling the convergence criteria convincingly[2], and subsequently reneging on their SGP commitments.

A compelling explanation is that the often inadequately acknowledged cleavage at the heart of EMU is between its two most prominent protagonists and core members: France and Germany. Many of the loose ends and shortcomings in governance can be traced directly to the competing French and German visions and the tensions between them have been an obstacle to more effective governance. France has a long tradition of active exchange rate management, whereas Germany has stressed stable money. The sharing between the Council and the ECB of responsibility for exchange rate policy is a fudge that leaves neither in charge and reflects neither country's predilection. For Puetter (2004) German scepticism about *gouvernement économique* derives from fears that it would compromise the independence of the ECB. The make-up of EMU is a compromise between what Pisani-Ferry (2006) describes as a German preference for avoidance of excessive deficits and a French insistence on the necessity of co-ordinated non-monetary economic policies. But he also notes the asymmetry between the loose nature of the latter and the hard rules of the former. The 'S' in SGP is a German preference, whereas the 'G' is a concession to French concerns about more active demand management. In the 2001-03 recession, it seemed that the two countries were more in harmony in promoting a more flexible interpretation of the SGP, but with Germany having consolidated its public finances over the last couple of years, they again appear to be on opposite sides.

Fresh tensions have surfaced around the strength of the euro relative to the US dollar. Mundschenk and Münchau (2007) reject the received idea that the problem is between the ECB and political leaders, but is instead about conflict between politicians. Indeed, they argue that in any contest between the central bankers and politicians, the latter would always win – but only if they were united. Yet such unity has been far from evident concerning the euro, leading Mundschenk and Münchau to assert that 'the real threat to the cohesion of the monetary union is not Italy, or even a post-property-crash Spain. The real issue is the political gulf between France and Germany. The Franco-German dispute is a reminder, if any was needed, that these are two countries that have ideologically not moved an inch since the negotiations of the Maastricht Treaty. On the contrary, they have learnt to distrust each other more since the start of the euro'.

1.3 Structure of the essay

This essay looks at the governance of EMU and how it may need to evolve as the euro area enlarges. The next section looks in more detail at the meaning of governance, explores the challenges of co-ordination, and considers their salience for the euro area, while section three assesses the record of EMU's first decade. For an enlarged euro area, there are diverse challenges to be met, and section 4 explores some of these. Section five then looks at ways forward for governance, and the last section concludes.

Various themes emerge in the essay. A first is the importance of recognising that EMU has moved a long way in its first decade and that the parameters for governance have, consequently evolved. A more mature and embedded EMU needs new principles, pointing to a second theme which is that the political dimensions of economic policy making deserve to be made more explicit, while unresolved issues such as divergent visions and preferences have to be confronted and settled. Third, enlargement of the euro area ought to take account

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[2] A very benevolent view is required to regard Italian debt as having been converging rapidly to the 60% of GDP threshold.

of the different circumstances of the potential new members. Looking forward, it is questionable whether a one-size fits all system for fiscal and structural policies can be retained, and whether greater differentiation should be contemplated. Similarly, can a system reliant on 'soft' modes of governance be enough in an euro area of twenty or more? Channels for promoting legitimacy warrant fresh thought, given the widespread disquiet about the perceived democratic deficit.

2 Governance

What is meant by economic governance[3]? It combines the philosophy and architecture of economic policy-making with the institutions, machinery and practices that shape the evolution of the economy. What has progressively been put in place in the EU is a system that has distinctive characteristics. These can partly be explained by the manner in which integration itself has evolved, partly by reference to the experience gained as the EU has evolved from the customs union to EMU, partly by the manner in which ideas about economic policy-making have changed, and partly by how policy actors have 'learned-by-doing'. Six facets of governance can be distinguished in a framework for appraising the system as a whole.

A first is what might be termed the **policy paradigm**, which can be explained as the theoretical or conceptual basis - or model - for the conduct of policy. While there will often be competing models, at any point there is likely to be a dominant view – or orthodoxy - that sets the parameters within which choices are made and focuses the content of policy discourse, while options rooted in alternative models cannot easily be put forward for consideration. The dominant paradigm will tend to evolve only slowly, though there may be very pronounced shifts from one decade to the next. In EMU today, the term 'stability-oriented'[4] captures the dominant model for macroeconomic policy, though the expression 'new Keynesian/neo-classical synthesis' might more accurately reflect the academic literature. Its focus is on identifying and correcting microeconomic market failures and government failures (especially time inconsistency), dealing with them in a quite interventionist/activist manner, with the underlying ambition to strengthen market forces. Key characteristics include a belief in the neutrality of monetary policy and relatively restrictive fiscal policy.

The second dimension of governance can, loosely, be labelled **approach to policy making**, comprising the nature of policy processes (such as the formulation of rules or restrictions on discretion), the degree of legal codification of the policy machinery, whether targets or benchmarks are employed and the character of decision-making. Both the EU and EMU today have rather diverse methodologies in different policy domains. Rules are, ostensibly, central to both fiscal and monetary policies - though the experience of the SGP suggests a disjunction between principles and implementation - and even ECB policy in practice often suggests that more discretion is exercised than is commonly assumed. By contrast 'softer' methodologies for policy co-ordination are more evident in other policy domains, especially those lumped under the Lisbon strategy. A key observation is that economic governance largely eschews political processes at the heart of EMU policy-making. In the re-launched Lisbon strategy, especially, it can be argued that a form of hybrid governance has emerged in which methods that can be categorised as the traditional "méthode communautaire" (especially in much of the Community Lisbon Programme which includes internal market measures) function alongside the open method of co-ordination.

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[3] These issues were discussed from a DG Ecfin perspective in Commission (2004)

[4] Pisani-Ferry et al (2008) note however, that there are multiple facets of stability, including prices, public finances, financial markets, the real economy and what they term 'agility,' defined as the ability to cope with shocks or crises, especially in bad times

Third is **the institutional mix** which concerns the division among the different tiers of government (EU, national, sub-national), and the split between governmental and other forms of governance, including agencies or forms of self-regulation by private actors. Here, too, the EMU system is very diverse, with dominance of the Member State level of government for fiscal and structural policy; an independent executive agency (the ECB) responsible for monetary policy; shared competence between the Commission and Member State agencies for competition policy, and so on. Although most economic policy measures are supposed to function at the Member State level, co-ordination of these measures raises awkward questions. A second, key issue is what role the Community level should have and how it is exercised. While the respective roles of Member States and the Community institutions, in partnership, are becoming clearer, the implications of 'hybridity' - in the sense described above - as a model of governance remain to be fleshed-out.

A fourth dimension, of a more political character, is **accountability and legitimacy**, embracing not just the mechanisms through which institutions of governance are held to account, but also the different facets of legitimacy. The dichotomy between input and output legitimacy posited by Scharpf (1999) offers one means of analysing the challenges of economic performance by asking whether it is better to have institutions of governance that are not, at first sight, subject to democratic oversight, provided that they deliver better outcomes. Legitimacy cannot be reduced to an exclusively positive assessment as it has many normative dimensions. 'Better' performance as an arithmetic average may hide significant distributive differences and the preferences of the population need to be appraised with subtlety. At issue here is not only whether mechanisms exist, but whether they function effectively in ensuring that economic governance is consistent with political preferences.

Fifth, and related to the fourth category, is the issue of **transparency and communication** which bears on governance from two quite distinct perspectives. The first is provision of information that allows the agency of governance to be held to account and can thus be interpreted politically. The second is communication strategies that inform economic agents subject to the policy area about the stance of policy in a way that is conducive to optimal behaviour. For example, central bank transparency has come to play a pivotal role in the conduct of monetary policy. Communication also encompasses the transmission of information from the governed to the governing agency, including how receptive the latter is prepared to be in responding to emerging signals.

A sixth component of the economic governance framework is the **range and scope of participation by different actors** in policy-making. Among the key aspects of this are where effective 'ownership' of the policy area resides, how different constituencies are heard (for example, formal consultation or informal lobbying), whether there are either effective vetoes or provisions for constraining the autonomy of the decision-making body, and the means by which competing positions are reconciled. One of the most forceful criticisms of the Lisbon strategy concerns the lack of ownership. Too often, the European Parliament is inaudible, while the voice of civil society is rarely listened to by decision-makers. By contrast, the ECB is often attacked for being too deaf to demands for policy changes emanating either from other public authorities or wider constituencies.

2.1 Policy co-ordination

The manner in which macroeconomic policy is conducted in the euro area has no real parallel elsewhere. In particular, what distinguishes it is the nature and conduct of policy co-ordination; indeed many of the most disputed aspects of EMU governance concern the extent and purpose of co-ordination. In the academic literature, co-ordination has traditionally been about the scope for orchestrating the thrust of policy (Williamson, 2005), usually in response to perceived disequilibria or common shocks such as the response to the oil price increases in the 1970s, the falling dollar in the mid-1980s or, today, the accumulated effects of imbalances and the fall-out from the sub-prime crisis. More systematic macroeconomic management at global level has been an aspiration that has not been achieved. By contrast, in the EU, and

especially around EMU, policy co-ordination is intended to be more routine and has taken a variety of forms, embracing both macroeconomic and structural policies.

The virtues of co-ordination are hotly disputed. Minimalist co-ordination encourages greater accountability because it means that 'principals' can more easily ascertain whether 'agents' have done what they are supposed to do, whereas attempts at co-ordination between fiscal and monetary policy in the pursuit of a 'right' policy mix will blur roles and weaken commitments (Alesina et al., 2001; Issing, 2002). The alternative view is that strong co-ordination is needed to articulate an explicit policy mix, defined here to include not just the traditional combination of fiscal and monetary policy, but also structural policies. Calmfors (2001) identifies five lessons about policy co-ordination

- There need to be significant cross-border spillovers to warrant co-ordination
- There has to be evaluation to ensure that commitments are adhered to and that policy co-ordination is achieving results, otherwise free-riding will be encouraged.
- Even if there are gains from co-ordination, they can be negated if decision-making is ineffective.
- Policy innovation is inhibited
- Country diversity is not given sufficient attention, with co-ordination aims over-shadowing national preferences or needs.

2.1.1 Co-ordination in EMU governance

The constitutional position regarding co-ordination was, largely, established in the Maastricht Treaty and only marginal changes have been incorporated in the Lisbon Treaty. The principal mechanisms today are the SGP, covering fiscal policy, and the Lisbon strategy which now incorporates the Broad Economic Policy Guidelines (BEPGs) – in place since the early 1990s and covering different economic policies - and the Employment Guidelines initially known as the Luxembourg process. What is lacking however, are explicit mechanism for co-ordination between fiscal and monetary policy, or for aggregating Member States' fiscal policies. Two significant reforms have, however taken place since the original Maastricht criteria were promulgated, despite the fact that the Treaty has been unchanged. These are:

- The adoption of the SGP in 1997, which did not explicitly refer to the debt ratio as a rule (although, obviously, it remained in the Treaty) and created the conjunction of the close-to-balance target for public finances and the 3% deficit limit
- The reform of the SGP in 2005, with the introduction of more political discretion, a change in the definition of a steep fall in GDP growth, and other corrections

One of the key challenges of fiscal policy co-ordination is striking the right balance between what many authors (Buti and Pench, 2004; Annett, 2006) have described as preventive and dissuasive policies. The SGP, manifestly, embraces both, yet has been bedevilled by an enduring ambiguity about where the policy emphasis should lie. Indeed, Pisani-Ferry (2006: 828) asserts that the institutional provisions for fiscal co-ordination are 'markedly weaker … than those inspired by the need to safeguard central bank independence and price stability'. Enforceability is seen as a key attribute of a 'good' fiscal rule, but if tested against this attribute, the SGP performs poorly (Buti et al., 2003). The approach to enforcement is a mish-mash of hard, soft and informal methods; they are rule-based and discursive; and political as well as technical. The EDP can be criticised as a procedure that ought to be used sparingly, but which (because the Commission has no choice but to act if Member States breach the rules) over the years has become routine, undermining its credibility.

In the run-up to the 2005 reform of the SGP, there was a cascade of proposals for its revision (for two overviews, see: Fischer et al., 2006; Verde, 2006). The reforms eventually agreed sought to strengthen the economic rationale behind the Pact while augmenting political discretion, but instead of a simple rule, introduced more complex governance arrangements

for fiscal policy. The changes agreed did not go as far as many protagonists hoped in emphasising public debt as the yardstick of sustainability of public finances, yet also cast doubt on whether it would encourage responsible fiscal policy. Three questions then arise:

- Can governance mechanisms be devised that are capable of applying discretion without tending towards a breakdown of fiscal discipline as Member States refer to the 'jurisprudence' of treatment of others?
- In a softer regime, is there any way to contain the propensity of governments to use fiscal policy for electoral reasons? Buti and van den Noord (2003) argue that systems of surveillance are unlikely to be robust enough to deter such opportunistic behaviour by governing parties. Although they find that governments often build up 'war chests' by fiscal austerity in non-election years, few have gone as far as would be implied by the SGP.
- Do the methods employed for assessing fiscal positions provide accurate and unambiguous information? Accounting tricks may have undermined discipline (Buti et al., 2007) although the 2005 reforms of the SGP, by stressing debt, will diminish the scope for playing-off debt against deficits. However, Balassone et al. (2006) show that neither a debt criterion nor a deficit one, on its own, provides an adequate yardstick of fiscal sustainability. Instead, they argue for consistency cross-checks between the two classes of indicators, observing though that all fiscal indicators are susceptible to distortion. One dimension of the fiscal sustainability that does not receive due attention is the net worth of the public sector, both in a conventional balance sheet sense and, considering off balance sheet items, the prospects either for future flows of income (user charges, for example) or of outlays (such as pension obligations). Yet in the final analysis, the problem is less the computation of the ratios so much as the reluctance (or inability) of Member States to abide by the rules.

2.1.2 Bringing in the supply-side

As in any polity, in EMU there is a three way interaction among monetary, fiscal and supply-side policies, and decisions in each will be influenced by what happens in the others. *Ceteris paribus*, the ECB will find it easier to maintain price stability (its primary mandate) if the fiscal authorities maintains a tight fiscal policy. Interdependencies between fiscal and monetary policies are much discussed, but it is in the area of structural reform (including its connections to monetary policy) that, arguably, the rationale for co-ordination is least well developed. If product market competition and/or labour market flexibility (broadly defined) are enhanced, the likelihood is that inflationary pressures will be muted for a given pressure of demand. This cuts both ways, harking back to the 'two-handed' approach to reform, dating from Blanchard et al. (1986), which argues that structural reform is much less likely to take hold if it is not accompanied by demand conditions that are supportive.

In a typical national setting this can then become either an explicit policy mix in which the settings of fiscal, structural and monetary policy are negotiated, or can be the outcome of a tacit recognition by one of the agencies (typically, with central bank independence having become the norm, the monetary authority) that the decision of the other affects its own (given the framework for EMU, the more likely option). As a result, the central bank can also be expected to factor-in to its judgements on monetary policy how the supply-side is evolving. The central bank reaction function would, in this logic, include the stance of fiscal and structural policies as an independent variable. The key point is that in a 'normal' polity, the fiscal authority that exercises discipline or the supply-side authority that delivers greater flexibility can expect a 'reward' in the form of lower interest rates. Conversely, loose fiscal policy or supply-side rigidities will be penalised by higher rates.

In the euro area, a notable difference is that fiscal or supply-side actions by Member States will be diluted because they have only a small weight in the overall calculation by the central bank. Even Germany accounts for below a third of euro area GDP, implying that fiscal

consolidation by Germany will only attract a third of the pay-off that it would have compared with the DMark era when the counterparty of the German government was the Bundesbank. The significance of the arithmetic of the linkages is, first, that because governments adopting 'virtuous' policies will see less pay-off, lowering incentives to do, and second, governments that do not comply face lower penalties and thus greater temptations to free-ride.

The political economy of structural reform makes the links between monetary, fiscal and structural policies hard to assess. Leiner-Killinger et al. (2007) in surveying the literature on the links between structural reform and monetary policy suggest that, on balance, EMU should stimulate structural reform and diminish opposition to it. However, for countries which, on joining a monetary union, benefit from a lower nominal interest rate, monetary union may stimulate the economy in the short- to medium-term, and mask structural problems. Yet Tabellini and Wyplosz (2006) make a convincing case that supply-side co-ordination in the EU at present is neither optimal nor well thought-out. Nevertheless co-ordinated structural reform (Bentolila and Saint Paul, 2001) deserves attention, although the modalities and focus matter, given that co-ordination in structural policies works least well in the labour market, but is more promising in other areas.

Solving the problem of lack of national ownership of Lisbon strategy commitments will not be easy and there is an air of unreality to many of the solutions canvassed, however well-intended or sensible in principle. For example, Tabellini and Wyplosz (2006) call for national parliaments to be obliged to debate the recommendations of the European Council in relation to labour market reform. Yet it is hard to see even the more compliant of national assemblies being receptive to such an obligation, while many would positively bristle at it. Similarly, the criticisms in the Kok report of Member State commitments to the Lisbon strategy suggest a lack of credibility. The upshot is that neither macroeconomic constraints nor supply-side reforms have been able to garner sufficient credibility.

A euro area component to the Lisbon strategy – orchestrated by the Eurogroup – could contribute to better linkages between the demand and supply sides of the economy. This has already been foreshadowed in the Commission's 2006 and 2007 Annual Progress Reports on the Lisbon strategy in which there were not only separate 'fiches' for each Member State, but also one for the euro area as a whole. The problem though is that while the fiche contains suggestions for the euro area, it is less clear what institutional machinery there is within the euro area to act on these suggestions, although the Eurogroup is the body that has the potential to be the relevant actor.

Yet there is manifestly a problem where the intensity and content of structural reform differs from one country to another, and where the value of any accompanying demand-side stimulus will be uneven. Moreover, since the degree of any demand-side stimulus cannot easily be tailored to the circumstances of an individual country when the ECB can only set a single monetary policy, the challenge is greater still. Pisani-Ferry (2006) suggests that 'the ECB should explicitly let it be known that provided there is a common political commitment to reform and without prejudice to price stability, it stands ready to back policies that lower structural unemployment and put the euro area on a higher growth path'.

2.1.3 Track record

The implementation of policy co-ordination has been mixed. In the fiscal arena, it has arguably had enough of an impact to prevent much resort to discretionary fiscal policy, yet has not been sufficiently potent to bring down debt by pushing countries to respect the 'close to balance' requirement of the SGP. The evidence of relatively disciplined fiscal policy over the first decade of EMU suggests that the SGP *has* constrained governments, though it seems to have done so more via the 'soft' pressures of peer esteem and calling into question of their domestic reputation for competence, than the hard sanctions of the last two stages in the EDP (obliging a Member State to deposit up to 0.5% of GDP, then the conversion of the deposit into a fine) which have never been, nor are likely to be, used. The relationship between the 'hard law' of the SGP and the softer 'recommendations' under the BEPGs (or, now the

macroeconomic elements of the Lisbon Integrated Guidelines) has proved to be an uncomfortable one and there is force in Pisani-Ferry's criticism (2006: 836) of the BEPGs as having 'become a "Brussels talking to Brussels" exercise, with little impact on national policy processes, let alone decisions. Yet it is often the softer elements that have proved most influential (Hodson and Maher, 2004).

In structural policies, the record is less convincing, prompting questions about whether more explicit incentives or procedural changes are needed? Even the re-launched Lisbon strategy is undermined by a lack of hard cash (Pisani-Ferry and Sapir, 2006), despite the Kok recommendations. In these circumstances, it is unclear what the incentives are for 'good' policies if there are short-term political costs of tough measures. An easy answer to the sheer complexity of co-ordination is simply not to try it on the grounds that, even if well-intentioned, it will make matters worse by blurring incentives and fostering uncertainty. But this would be unduly defeatist and, instead, the imperative should be to find ways of avoiding the pitfalls. One suggestion (Leiner-Killinger et al., 2007: 22) is that the ECB could signal its likely reaction to specified reform measures, thereby contributing 'to reducing the typically large degree of uncertainty surrounding the outcome of reforms'.

The 2006/7 'fiche' for the euro area, annexed to the Commission's *Annual Progress Report*, states that the 'euro area Member States should aim at deepening co-ordination and strengthening governance, especially in the context of the Eurogroup' a change that, it is claimed, would 'contribute to more effectively address policy challenges'. If the euro area is to improve on how structural policies interact with macroeconomic policies for reasons of good governance of EMU, it is the obvious way forward. The nub of the question, though, is whether a euro area member would do anything differently because it is part of the euro area, and in this context, three options can be considered. The first would be that a different policy is adopted; and the second, a country might act on a different timetable, either by implementing reforms in a sequence or by doing them sooner. But it is the third that is more intriguing: would a country be more willing to act because it was in a closer co-ordination process?

2.2 The institutions of euro area governance

Not surprisingly, the institutional structure of euro area governance is somewhat messy. EMU is in a curious limbo insofar as its institutional structure very largely presumes that all members of the EU will join the euro area and that non-participation is a derogation (except for Denmark and the UK with their formal opt-out provisions). But with barely half the EU Member States fully in EMU as it approaches its tenth anniversary, the temporary character of the transition is open to question. Certainly, anomalies arise in governance: all Member States are subject to surveillance in fiscal policy and are subject to the Excessive Deficit Procedure, yet only the full participants face sanctions under the disciplinary provisions of the SGP.

Machinery for dealing with policy trade-offs – in other words, for articulating policy preferences – is, however, lacking and, in political economy terms, there is a potential for conflict in the short-term between governments in obtaining a higher share of demand in response to a common monetary correction. An answer is to co-ordinate (and, by implication, to share out) a common fiscal stance. Such a process is not sufficiently approximated by the existing co-ordination arrangements, and can therefore result in a sub-optimal macroeconomic policy. Von Hagen and Mundschenk (2003: 293) conclude that 'the current institutional setup largely keeps the member states in a non-cooperative policy game' and that this, in turn, justifies the central bank in not co-ordinating what it does with the (divided) fiscal authorities.

The division of powers between the ECB, the Council of Ministers (or the Eurogroup) and the Commission may even give rise to technical complications when there is uncertainty about key variables such as the true output gap or the projected fiscal deficit (Balboni et al., 2007: 4) who show that 'almost universally, the texts adopted by the Council are softer than those put forward by the Commission'. It follows that a governance challenge is how to reconcile conflicting views on the true position of the economy.

2.2.1 Eurogroup

Since the start of stage 3, the Eurogroup has progressively become the most influential political forum for the governance of the euro area. It came into being for two distinct reasons: first, because the body formally charged with over-seeing the economic dimensions of EMU (Ecofin) has to balance the interests of the euro area and those of its other members; and, second, because the incomplete membership of full EMU created an institutional vacuum in matching the economic and monetary aspects of EMU. The fact that the Eurogroup membership is a majority of Ecofin is important, because it means that even informally agreed positions can become policy, provided that the caucus remains firm. Equally, if a measure either requires unanimity or is currently blockable, but only pertains to the euro area, any attempt to block it in Ecofin will engender resentment.

Above all the Eurogroup's activity is debate on economic developments and policy-making, not legislative activity. But it is evident that the Eurogroup has become the de facto forum for deciding on breaches of the SGP. The Commission also can use the Eurogroup as a channel to convey messages to Member States, especially about fiscal discipline. In addition, having adopted a more permanent presidency from the start of 2005, a greater degree of continuity has been introduced. The European Parliament has responded to these changes by inviting the president of the Eurogroup to attend a meeting every semester (half as frequently as the ECB, however). What appears to be happening is a kind of creeping institutionalisation of the Eurogroup that has been taken a stage further by new provisions in the Lisbon Treaty. The new chapter 3a provides enabling clauses to enhance euro area governance, effectively defining the equivalent of Art. 99 co-ordination for the euro area.

It still, however, represents a compromise insofar as the Eurogroup will remain informal (although a potentially significant development is that any Council votes on budgetary surveillance or economic policy guidelines will be limited to the euro area members (Art. 114.2). Similarly, the new Art. 115a provides for common euro area positions and representation in international financial institutions, though only in enabling rather than prescriptive terms, prompting the question of whether privileged Member States will forgo their existing rights. Art. 116 also sets out a range of areas in which non-members of the euro area will not have decision-making powers, such as in nominating ECB Executive Board members.

The question that arises is whether the informal Eurogroup of the early years of the euro is a creature of its time which will have to emerge from its chrysalis in an altogether different form. Informality, together with the one-plus-one membership has encouraged full and frank debates and the absence of formal record encourages greater candour. Reaching consensus is at the heart of the method. The Eurogroup, according to Puetter, acts as a complement to formal procedures, rather than as a nascent economic government – a crucial distinction. Because of informality, peer pressure can be more effective. The Eurogroup is also reported more recently to have gained in confidence and authority helped in part by the shift to a more permanent president, but also because it has simply matured enough to have learned by doing.

Despite these new provisions in the Lisbon Treaty, the Eurogroup will not acquire legislative powers, so that although its status will be boosted, it will remain an informal body that lacks the authority to enforce decisions other than through peer pressure. Indeed, it would be open to question whether it would even possess executive/administrative powers other than through the medium of Ecofin. Yet the accretion of power to the Eurogroup is manifestly a sign of change in governance, despite its unplanned character.

An evident problem is that the Eurogroup is composed of finance ministers, whereas many structural policies engage other ministries, notably those responsible for labour market and employment policy, enterprise, social protection and technology. These other ministries will, to a degree, have different 'client bases' among economic actors. It follows that, by being limited to finance ministries, the Eurogroup's influence over the ministries responsible for

structural reform is less clear. Should there then be informal groupings parallel to the Eurogroup for issues normally covered by EPSCO and the Competitiveness Council? Alternatively, should a variant on economic government that cuts across sectoral policies be envisaged? On all these matters, the Lisbon Treaty provides no formal proposals, although further informal developments should not be precluded.

The decision of Nicolas Sarkozy in July 2007 to attend the Eurogroup and to make demands on the path of fiscal policy (to the evident dismay of other members and the ECB) highlighted two factors. First, if heads of state or government do become involved, they can be expected to shape the agenda in a manner that might not be congenial to finance ministers and might over-ride them. Consider, for instance, what would happen to the hard-fought consensus on fiscal discipline and improving preventive measures if more members of the European Council came to share Sarkozy's enthusiasm for more discretionary fiscal policies. Second, the cosy but closed nature of the Eurogroup may be weakened and it may have to become more transparent. Nevertheless, the most likely way forward is for the Eurogroup to be the focus of EMU economic policy making, yet progressively to bring in other segments of government, so as to embrace the full range of economic policies at issue. Ultimately, the membership of the Eurogroup might well mutate towards being Euro area ministers with wider economic responsibilities, rather than just finance ministers.

2.2.2 The Commission and other institutions of governance

In the governance of the euro area, the Commission is bound to be a central actor. It has a range of roles, some of which are evident and accepted, while for others there is a pronounced ambivalence about how much power or influence it should have. The accepted roles include the core analysis of EU economic developments, the surveillance of Member State policies, and the procedural elements of the various stages in implementing the SGP, the Lisbon strategy and other co-ordination processes. However, where the Commission's role comes in for most criticism or appears to be resented by Member States is in the exercise of disciplinary measures and in criticising policy developments.

Since the 2005 re-launch of the Lisbon strategy, the Commission has become more central in economic governance than in the early days of EMU, and has regained (or acquired) greater influence over the direction of policy-making. It has done so, first, by being the prime mover in establishing the Integrated Guidelines that Member States are asked to use in formulating NRPs. Where this is different from previous experience is that Member States could, on the whole, take little account the BEPGs if they so chose, although the Employment Strategy (and social inclusion National Action Plans) arguably put DG Empl in a (possibly more emphatic) pivotal role. Second, the Commission is now very much centre stage in the policy procedures, as the principal orchestrator of the annual Lisbon cycle, as well as being the leading agent for the delivery of the Community Lisbon Programme. In addition, it is evident that the Commission devotes greater collective effort to 'Lisbon', having given it the highest political priority, broadened the range of Directorates-General engaged and established a strong central co-ordination of its contribution at very senior level.

However, where the Commission appears still to be somewhat tentative is in the degree to which it is openly critical of Member States. In 2005/6, the Commission chose not to issue national recommendations and had already elected not to use overt naming and shaming, despite this being a strong recommendation of the Kok committee (Pisani-Ferry and Sapir, 2006; Begg, 2006). In 2006/7, national recommendations were restored, but have been drafted very guardedly. Although the Commission has been more forceful in bi-lateral discussions with Member States over the content and implementation of NRPs, the fact that it has largely been behind closed doors may have undermined transparency in a way that diminishes the domestic pressures on governments to take full ownership of reform strategies.

The Lisbon treaty strengthens the Commission by providing under Art. 99 for the Commission to be able to criticise Member State economic policies and to issue proposals rather than mere recommendations concerning excessive deficits. The protocol on the

Eurogroup also provides for the Commission, as well as the finance minister to prepare meetings – arguably legitimating an activity currently undertaken by the Commission, but open to dispute.

Key roles in the governance of EMU continue to be played by expert committees, especially the Economic and Financial Committee (EFC) which prepares Ecofin meetings and its working group responsible for preparing Eurogroup meetings, the Eurogroup Working Group (EWG). Both these bodies work very much behind the scenes, do not publicise their activities using a web-site and rarely produce public reports. Yet they are manifestly highly influential, with the EFC often perceived to be first among equals of the various expert committees. The EFC meets in two formations (the full committee, including national central bank officials) when discussing the general economic situation, financial stability and IMF topics, and in a restricted formation that excludes NCB officials when discussing other matters.

2.2.3 Scrutiny: the European Parliament and the Committees

Scrutiny of economic policies is shared between the Commission, the European Parliament and various committees, with formal provisions alongside procedures that have evolved as EMU itself has matured. They are subject to two particular sources of tension: first, a degree of balkanisation of scrutiny and, second, disparities in impact. The European Parliament has a comparatively strong role vis-à-vis monetary policy, but a much more diffuse one in relation to structural policies, not least because its Committee structure does not map easily into the broad range of areas covered by the Integrated Guidelines. There is a Lisbon Co-ordinating Committee in the Parliament, but it is informal and does not have the political clout of sectoral committees.

By all accounts the scrutiny of Member States' 'Lisbon' NRPs by the Economic Policy Committee and the Employment Committee is effective, if rather truncated. These committees do provide peer review, possibly the only real way in which peer review is exercised. The European Economic and Social Committee contributes to governance through its work on the engagement of social partners and other interests, albeit with limited impact. Overall, what is lacking is a more systematic attempt to pull together the oversight of governance processes (Begg and Larsson, 2007), other than very rapidly at the spring European Councils, and these Councils often have other, more pressing business. The danger, therefore, is that scrutiny, although exercised diligently, does not feed into wider evaluation of national policies.

3 How well has the system functioned?

Governance of the euro area has, in many ways, been more effective than it is often given credit for and it is easy to forget some of the predictions of doom that surrounded the birth of the euro. Consider, for example, the statement by Martin Feldstein that 'the shift to EMU and the political integration that would follow it would be more likely to lead to increased conflicts within Europe and between Europe and the United States' (Feldstein, 1997). The same author – a dependable straw-man in this regard – has argued more recently that 'fiscal independence would not be such a pressing problem if the existence of a single currency did not create a bias to chronic budget deficits' (Feldstein, 2005: 7). He conveniently overlooks the fact that public finances have been tolerably stable, despite the problems some Member States had during the last early years of this decade.

However, even if the legitimacy of the governance system is assessed in terms of outputs rather than democratic accountability, the fact that the improved economic performance that was expected from EMU has not (yet?) materialised engenders criticisms. These focus on the choice of monetary policy strategy (which some believe to be behind the state of the art – for example, Pisani-Ferry et al., 2008, advocate a shift to inflation targeting), the overly rigid application of the SGP, and the incoherence of supply-side policies. It would be easy to dismiss the shortcomings in economic performance as the teething troubles of a very ambitious change in policy regime and it is important to distinguish between transitional

problems that have undermined economic performance and aspects of the governance of EMU that have proved to be sufficiently dubious to require attention. For example, how can widening divergence, especially in competitiveness, be addressed? Similarly, if different trajectories of structural reform accentuate the differences between Member States, there are likely to be repercussions for transmission mechanisms that complicate or undermine the functioning of monetary policy.

3.1 What has worked well

Pace Feldstein, there is much to commend in the first decade of EMU. So far, the ECB has, by and large, delivered price stability and the consensus seems to be that the ECB has not been unduly severe in the priority it has given to stability. Thus, Wyplosz (2006) argues that the Eurosystem has been wise in its policy decisions and has not slavishly followed what its own statements indicated it might. To this extent, publicly stated principles and action have diverged. Clearly, too, the EU has seen a strong convergence in inflation rates, both inside and outside the euro area, and the data show that inflation is now low across the EU and exhibits few signs of any resurgence.

Volatility in the real economy has also declined, though towards steadier but lower growth rates. Whether this is because of the governance changes adopted with the aim of assuring stability (and not just in the euro area), the pressures of international competition or behavioural changes in societies that recognise that inflation is ultimately pernicious, is an unresolved research question. However, recent signs suggest that supply-side improvements are now contributing in key countries like Germany.

Some critics argue that the SGP is effectively dead (Calmfors, 2005; Buiter, 2006), but a conclusion of this essay echoes that of Mark Twain – rumours of its demise have been seriously exaggerated. Adherence to the letter of the Pact manifestly has not been perfect, but compared with the excesses of the pre-Maastricht era, fiscal deficits have been surprisingly restrained (Hughes Hallett et al., 2004). The revised SGP has more economics, more scope for (sensible) political discretion and less of a hidebound resort to rules. It also (see Verde, 2006) has more country specificity and is more likely to assure long-run sustainability, though Verde considers that the new flexibility may be excessive. Nor is there any persuasive evidence that the limited breaches of the excessive deficit rules have led to higher interest rates. This may sound like a Panglossian conclusion, considering the SGP's previous problems, but it is important to distinguish between the methods and institutions of governance of the euro area and underlying structural weaknesses. The latter as Paul de Grauwe has insisted (see, for example, de Grauwe, 2002; and the comments by Nickell on Wyplosz, 2006) predate the euro and cannot, consequently, be blamed on it. Fiscal discipline has improved partly because there has been a trend towards greater centralisation (within Member States) in budget setting, and more power to 'delegated' finance ministers, according to Hallerberg et al., 2006. It is an open question whether an inference to draw is that centralisation at EU or euro area level might add to the discipline. Certainly, the willingness of the Eurogroup to discuss timetables and orientations suggests that there is a disposition to go in this direction. Buti (2005) has also advocated a split of the fiscal year into a euro area semester and a domestic semester.

3.2 What remains unsatisfactory

Although fiscal co-ordination has worked better than it is often given credit for in maintaining discipline, it has not yet found the answer to two related problems. The first is delivering a coherent euro area fiscal stance to complement monetary policy. It may be attained implicitly, but the scope for it to lead to unbalanced policy is still considerable. Second, the governance mechanisms have patently failed to fulfil the objective of fiscal consolidation in good times – the close to balance rule of the SGP. It may be that the rule is misconceived, but the lack of progress in many euro area countries in bringing down public debt ratios suggests otherwise. Annett (2006) suggests a number of explanations, including:

- Systematic over-estimation of the strength of the economy

- A disposition to resort to gimmicks or one-off devices to massage statistics
- The impact of elections

Solutions include trying to construct a common means of assessing the economy (which could be via independent forecasts, following Jonung and Larch, 2006) or by having independent institutions to the fore in managing fiscal policy (as advocated by Wyplosz, 2002), rather than government bodies.

A second problem is that the EU economy shows signs of increased imbalance that may threaten stability. Significant imbalances have emerged between euro area members, with large trade surpluses in Germany and the Netherlands, and burgeoning deficits in Spain and Portugal. Moreover, despite some improvement since 2005, unemployment remains doggedly high in several Member States. According to Blanchard (2006) many explanations of EU unemployment struggle to explain differences among countries. What is undeniable is that the EU as whole, despite achieving productivity levels close to those of the US[5], lags a long way behind in terms of GDP per head, adjusted for purchasing power. Arithmetically, the principal explanation is the significantly lower hours worked, but there are differing views on whether the explanation is a preference for leisure, the effects of high taxes on labour, an overly generous welfare state or the effects of union power in restricting hours worked. Gordon finds the first of these explanations to be the most powerful, but also notes that the drift towards flexibility in Europe has reduced some of the gap in recent years.

A third shortcoming is that the link between macroeconomic policy and structural policies is, at best, unsatisfactory. Although the Integrated Guidelines bring together the different strands of policy and call for a single National Reform Programme, these programmes do not often cut across conventional policy boundaries very effectively. Nor has the taking of ownership for structural reform – put forward as a key element of the re-cast Lisbon strategy – really happened and the aspiration that public and peer group pressures on governments would underpin commitments to reform has not been realised.

3.3 An interim verdict

The EMU governance system has strengths, but a larger euro area will pose new challenges. In term of the six categories of governance set out in section 2, a verdict is as follows.

Policy model: the core of macroeconomic stability and market-orientated reforms, together with a focus on the knowledge-based economy that can be said to be at the heart of EU economic governance is well-supported. It does not need significant change to cope with enlargement of EMU, although the emphasis between different elements (employment policies, research, education and social cohesion) within structural reform may be worth revisiting. There is also a tendency to gloss over the disagreements between the two largest euro area members (France and Germany) about some of the broad policy orientations within the stability model.

Policy approach: many of the mechanisms of economic policy governance have been under strain and have the character of unfinished business. Yet there is not an unambiguous direction for change either for the present euro area or for an enlarged one. The Sapir (2004) report emphasised the need to match governance methods to policy demands, including allowing Member States to choose how to deliver. Equally, the EU (and, by extension, the euro area) needs to have carrots as well as sticks. Hard law and soft law mechanisms work uncomfortably together and it is difficult to work out which is the more effective or dominant. A larger euro area will only accentuate these problems.

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[5] To the extent that the lower EU employment rate means that the least productive of the working age population are not in the workforce, the relatively favourable productivity figures can exaggerate EU performance (see, for example, Bourlès and Cette, 2006).

The institutional mix has one not inconsiderable virtue which is that it has, up to now, achieved the desired results, at least in the sense of making things happen. Yet in the economic as opposed to the monetary dimension of EMU it can have the appearance of being almost accidental in character and is likely to need reinforcement to cope with enlargement of the euro area. Some form of economic government is the most likely answer, but given the enduring differences between Member States and different classes of policy-makers about the virtues of more formal economic government it will need extensive consultation to shape it.

Accountability within the policy framework is open to question. Macroeconomic policy-making cannot be portrayed as a normative vacuum: policy choices have significant distributive implications, and a system that lacks such choice risks becoming a policy framework that lacks legitimacy (Jabko, 2003). There are established channels for holding the ECB to account, notably through the quarterly meetings with the European Parliament, yet it is a moot point whether the public sees it as sufficiently accountable. The independence accorded to national central banks derives from laws that, as Amtenbrink (2004) argues, legitimate the position of the central bank within the national constitutional order, but it is elected governments that are ultimately responsible to citizens for the conduct of economic policy. Here the governance system is less satisfactory. There is also a challenge to legitimacy in the perceived shadowy nature of powerful committees such as the Economic and Financial Committee or the Economic Policy Committee, even though they are composed of Member State representatives, while the Eurogroup's very informality and lack of reporting amount to dubious legitimacy. Enlargement of the euro area as such would not necessarily alter this facet of governance, but may afford an opportunity for innovation.

Transparency: has been a key development across the world in monetary policy, partly as an instrument of policy in itself, and partly as a means of enhancing accountability, and the ECB has espoused these principles. In economic policy, the record on transparency is less satisfactory, with shortcomings in the visibility of, and explanations for, both fiscal and structural policy that have undermined confidence in governance in many Member States. The point made by Wyplosz (2006) that some of the principles underlying the governance of EMU are outdated is telling, as is his observation that pragmatism in policy-making has seen these principles over-ridden where they conflict with economic realities. But it is not a recipe for sound governance. Arguably, the best way to square this particular circle is for policy-makers to explain more comprehensively why they have done what they have done.

The stress on 'ownership in the revised Lisbon strategy deserves to be stressed insofar as it has to be nurtured by timely provision of information, something governments have shown themselves to be reluctant to espouse. This is likely to be counter-productive, because the time lags in structural reform need more careful explanation. Yet the record suggests that openness about the Lisbon strategy's aims and rationale tend to be stymied by the reluctance of Member States to refer to it in policy-making. However, if enlargement leads to a more customised approach to reform policies rather than the one-size-fits-all approach implicit in having common integrated guidelines, an enhancement of policy communication will be desirable. An emphatic conclusion of this essay is, therefore, that transparency in policy-making should be enhanced.

Participation of actors is also patchy. The Commission has seen its role revitalised since 2005, but the limited input, whether in scrutiny or policy innovation, of the European Parliament and, even less so, national parliaments is problematic. Yet for EMU to build on what has been achieved in its first decade, it will have to engage diverse interests more effectively. Engagement of other stakeholders remains a weakness in governance, exemplified by the shortcomings of ownership in the Lisbon strategy.

4 The enlargement agenda

Within a couple of years, the membership of the euro area can be expected to increase to 19-20, and the fact that only two of the 27 EU Member States formally have opt-outs means that,

at some point, pressure will be placed on the others to deal with their derogations from full membership. Before much longer, it is likely that a further seven to ten members will join EMU, leaving only a small minority of members still as 'outs'. At the lower end of this scale, the number of members would be double that at the launch of the euro, and would be bound to affect the institutional configurations that have served since the late 1990s. Barring an implausible reversal of the UK position, all the new members will have a small economic weight but, *ex-ante*, will widen the divergence in economic conditions that macroeconomic policy has to manage.

A view from the prospective new members of the euro area is that the founder members want to slow down accession to EMU (Dabrowski, 2007). This "don't rush" policy, though informal, risks delaying structural adjustment and means that countries that, arguably, are perfectly capable of acceding are denied the benefits of membership. Instead, Dabrowski argues that the new Member States should have 'clear incentives to speed-up' fiscal adjustment. An interesting, related question is whether the governance of entry to the euro area is appropriate for 'pre-ins' facing conditions that are manifestly very different from those of the founder members in the 1990s.

To accede, all candidates have to meet the original Maastricht criteria which were developed for the circumstances of the EU-12 (subsequently, EU-15) in the early 1990s, but may now be inappropriate for the converging economies of central and eastern Europe[6]. For the countries of central and eastern Europe growth in total factor productivity has been the main driver of economic performance and, after an early phase of labour shedding, it is clear that real convergence is occurring. If these countries continue to succeed in achieving real convergence; they:

- Will have faster growth of real *and* nominal income
- Can expect an upward adjustment of their price level
- Have a need for substantial public investment
- Need to attract foreign direct investment and other capital in-flows, not least (in many cases) to offset high current account deficits
- Are already seeing rapid growth of consumer credit towards EU-15 levels, with knock-on effects on asset prices, but also on risks of financial instability
- May need some flexibility in exchange rate and interest rate policy to deal with supply shocks or dislocations

The key point is that the range of economic challenges is different from those that confronted the EU-15 in the mid-1990s (when shaky public finances and high rates of inflation afflicted several current EU members) and a logical response would be to apply different tests for EMU entry. The obstacle, manifestly, is that both the Treaty and the de facto jurisprudence demand consistency. Even so, the common-sense approach would be to adapt the EMU accession framework as much as possible while keeping the need for unduly provocative changes or Treaty amendments to a minimum.

The medium-term consequences of EU entry and the prospect of acceding to EMU may, however, give rise to vulnerabilities that differ in character from current euro area members. As Schadler et al. (2006: 3) put it: 'rapid catch-up inherently involves risks, whether from the large-scale use of foreign savings, the rapid growth in financial markets and bank intermediation, or simply the rapid pace of economic change. Certainly, policies to mitigate these risks and make them more transparent are critical'. In addition, EMU itself has moved on from the original convergence phase(s). Hence for prospective new members it is pertinent to ask whether change in the governance of EMU entry should be contemplated.

[6] For a more extended discussion, see Pisani-Ferry et al. (2008); see also, Nuti (2006)

4.1 The formal convergence criteria

With the benefit of hindsight, one of the reasons for the difficulties that the euro area has had to face in its early years is that some countries had carried out prior adjustment of their economies more comprehensively than others (Ardy et al., 2006). The upshot is that those countries which had not adjusted much were confronted with having to learn how to adjust under a new monetary regime against a backdrop in 2001-2 of a prolonged recession, a perfect example of a vicious policy circle. One of the lessons to draw from this experience is that although nominal convergence remains necessary, it is unlikely to be sufficient. Instead, future members of the euro area have to learn how to use other – possibly slower acting – policy tools either to diminish the need for adjustment or to substitute for the absence of monetary autonomy in the new regime. Equally, policies that give priority to catch-up will not necessarily call for the same policy mix as stability-oriented policies, even if stability is regarded as an important ingredient.

The transition from the current monetary regime, via ERM II, could be contentious, given that some future EMU members employ inflation targeting while others have fixed pegs. At present, three of the CEEC-9 (the nine central and eastern European Member States not in the euro area) have currency boards, one has a pegged exchange rate, while the others have forms of inflation targeting. All, however, will be obliged to demonstrate a stable exchange rate to be eligible for stage 3. Here a pre-entry governance challenge arises. For those with pegged exchange rates, it is the inflation rate which must take the strain of any monetary fluctuations, while for those with IT, it is the exchange rate that will tend to be more volatile. Moreover, the IT countries will, at some point, have to switch towards an exchange rate target to fulfil the obligation to participate in ERM II, while the currency board ones will have to use other policies to dampen price volatility.

4.1.1 The inflation criterion

In 2006, when Slovenia was accepted as a new member of the euro area, Lithuania was refused because its inflation rate was adjudged to be too high at a fraction of a percentage point beyond the permitted 1.5 points above the three best performing countries. This comparison was benchmarked against two Member States which were non-members of the euro area (Poland and Sweden). Lithuania was commended in the negative Council decision for its 'significant progress towards reaching a high degree of sustainable convergence'. The further statement that Lithuania's inflation was 'likely to stay above it [the inflation criterion] in the months ahead' proved to be prescient, with higher inflation in 2006 and 2007. It is, nevertheless, a moot point whether this decision made economic sense, especially as Lithuania (like the other candidates) is almost certainly subject to some Balassa Samuelson effects that raise measured inflation[7].

Nevertheless, the Lithuania decision attracted considerable criticism. The simple response is to argue that the Treaty is unambiguous and the 2006 decision on Lithuania was not only legally correct, even if economically dubious, but also reinforces the message that the criteria will be applied rigorously. The Treaty clearly states in Art. 121 (1) TEC that the reference value is derived from all EU Member States, ***not*** participants in stage 3, so that the decision based on low inflation in two non euro area countries was constitutionally proper. Yet, as Willem Buiter has made abundantly clear in various strongly-worded public pronouncements (see, also, Buiter, 2006b), that the decision on Lithuania cannot be justified purely on the statistical evidence, and even the fact that Lithuanian inflation has since accelerated is offset by the fact that it has maintained its exchange rate fixed against the euro. Instead, the decision can only be understood as being *pour encourager les autres*, and to reflect complementary

[7] Schadler et al. (2005) suggest that the effect will add in the range of 1-2 percentage points to consumer price inflation in CEEC-9, although more recent estimates by Egert et al. (2007) show that depending on how the BS effect is measured, the figure may be lower. Yet the fact remains that, according to Eurostat data, the price level in CEEC-9 is substantially below that of the euro area.

(yet unstated) qualitative elements, notwithstanding Jean-Claude Juncker's denials on behalf of the Eurogroup that there was any toughening of the criteria.

There is widespread agreement that the 'average of the three best' criterion used to assess inflation convergence is inappropriate given that there is now an obvious benchmark for the euro area as a whole. It is worth looking at the detail. In 1998, when the inflation criterion was used to determine the eligibility of the eleven founder members of EMU, the three benchmark countries were Austria, France and Ireland, all of which became euro area members. In the 2000 and 2002 exercises, one 'out' country was included (Sweden in 2000 and the UK in 2002); then in 2004 and both 2006 assessments, two of the three benchmark countries were not members of the euro area. The average figure used is unweighted, leading to a further cause for concern: only in 2002, when France, Germany and the UK were the benchmark countries, was the inflation criterion assessed against a substantial economic core, and in the last three assessments only small and medium-sized economies have featured.

A more intriguing element is explained by the Commission (2006: 37) for the 2004 exercise in which a decision was taken to exclude countries in deflation from being used as benchmarks. The rather glib explanation is that 'these countries could not be considered to be "best performers" in terms of price stability – as suggested by the Treaty Protocol, which refers only to an average rate of inflation'. This prompts two questions. First, what is the ideal for price stability: a rate above, but as close as possible to zero; or a rate that genuinely measures stability? The ECB reference value for price stability is measured HICP inflation of 2% or close to that level, not zero. It is also salient that consumer price indices do not fully capture changing relative prices, because of quality improvements and new products. Even with new approaches to computing indices, *measured* inflation of between 1% and 2% reflects no overall movement in prices (Boskin et al., 1996), implying that 'best' in inflation performance should not only exclude deflation, but also that rates between 1% and 2% rather than zero would be optimal.

The second question is whether, if it is legitimate to exclude countries in deflation, somewhere between 1% and 2% rather than zero could become a definition of 'best' consistent with the Treaty. Neither the Treaty nor the Protocol on excessive deficits clearly states what 'best performing' means. Defenders of the inflation criterion might retort that the 1.5 percentage point margin already provides enough leeway and that tinkering with the interpretation of best performing would be both counter-productive and unfair to those countries which have already been subjected to the tougher version.

The common-sense and economically literate approach would be a minor Treaty change to make the reference value the current euro area inflation rate, testing a candidate's capacity to cope with the rate actually being targeted by monetary policy. Such a change is not likely given that the final version of the Reform Treaty is now settled, but even with the existing Treaty wording a re-thinking of the interpretation of 'best' may be warranted[8]. Moreover, it can also be argued that precisely because catch-up economies are subject to some increase in the price level a minor relaxation makes sense. The key point being made here, though, is that a re-interpretation could be constitutionally permissible.

4.1.2 Fiscal convergence

Fresh thought on the fiscal criteria may also be warranted, although Treaty change is manifestly an obstacle. For the CEEC-9, there is a compelling argument for fiscal discipline to provide room for flexibility in dealing with the challenges of meeting the inflation or exchange rate obligations. Equally, insofar as sustainable debt is regarded as the main goal,

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[8] The Rosati report in the European Parliament (final version, 28.06.2007 – document A6-0264/2007) drew attention to the inconsistency of having a working definition of price stability for monetary policy purposes and the reference value, and also calls (implicitly) for allowance to be made for the Balassa Samuelson effect in converging economies. However, stronger wording in a draft report was amended prior to the adoption of the final version.

the existing criteria make little sense for countries with trend real and nominal growth rates double those of the founder members in the 1990s. A 3% public deficit and 60% public debt assure stable public finances so long as nominal[9] GDP growth is 5% or higher, roughly the average values for these variables at the time the criteria were established. Thus from a starting position of a debt stock of 60% of year 1 GDP, the debt stock would increase from 60 to 63 as a result of there being a 3% deficit, but GDP – the denominator of the ratio - would rise from 100 to 105. 63/105 is still 60%.

For most of the CEEC-9, rapid real growth and above average inflation rates combine to give nominal growth rates substantially above 5%. Consequently, the budgetary arithmetic is more favourable to debt stabilisation: as an illustration, a country with a debt stock of 50% of GDP, real growth of around 5% and inflation of around 3% would have nominal GDP growth of about 8%, and could maintain the stock of debt stable with an annual deficit of 4% of GDP. Higher deficits might well make sense for countries seeking rapid economic development and requiring higher levels of public investment for this purpose.

At the time of writing, the key fiscal indicators show that only Hungary falls outside a plausible comfort zone for the fiscal criteria. Poland's deficit is above the 3% threshold and both the Czech and Slovak Republics are taking steps to curb deficits above the limit, but the latter two have relatively low public debt, and Poland's debt is some twenty points below the euro area average. Certainly, compared with the much more fragile fiscal positions in the mid-1990s of most current euro area members, these data do not suggest that fiscal convergence need be an obstacle, except for Hungary.

The trouble with proposing any change is that both the history and the constitutional position are very rigid. Objections to a more customised approach centre on the risks of 'follow-my-leader' behaviour that would inevitably result in a collective deterioration in fiscal discipline. Yet in an enlarged euro area divergences in real economy trajectories are bound to be greater and tensions about the configuration of fiscal policy co-ordination must be expected.

4.2 Enlargement and governance mechanisms

Although the Eurosystem has, in general, functioned effectively in terms of decision-making and policy approach, there are issues that can be expected to surface as the number of members increases. The cap agreed on the number of members of the ECB Governing Council will, henceforth, bite and it remains to be seen how well the rotation procedure will work. A parallel question is whether the informal arrangement that has, so far, allocated seats on the Executive Board to the four largest Member States can persist. Padoa-Schioppa (2004) has argued that the ECB should be a 'wisdom-based' collegial system, yet 'reserved' seats are surely incompatible with this characterisation (De Grauwe, 2006a). Clearly, as the number of members rises towards twenty, the notion that four of the six executive board seats can be ring-fenced for the four larger founder members cannot be sustained. Yet who will be first to blink?

Even without the reminder from the sub-prime crisis, financial stability is likely to become a more pressing issue as new members join. The rapid increase in private sector borrowing and the likelihood that house prices will accelerate in rapidly growing economies will need greater attention than has been the norm (Begg, 2008), with implications for how the liquidity operations of the Eurosystem are conducted. In addition, the high degree of foreign ownership of financial intermediaries in most of the recently acceded Member States (Slovenia is the exception) will prompt questions about how supervision is conducted and may call for a more extensive engagement of the Eurosystem in such supervision. Article 105(5) is an enabling one, but may now have to be used to assign specific tasks to the ECB as provided for in Article 105(6), despite the obligation stated in Article 58 to respect national provisions on

[9] That is, GDP at current prices. The increase in this variable is the combination of rising prices and growth in output.

prudential supervision. In addition, thought is needed on the politics of the lender of last resort function, and on where the costs of depositor protection should ultimately fall.

An issue for the future governance of EMU is whether enlargement alters the conditions conducive to successful soft governance. Sheer numbers may well prove to be a problem. In a Eurogroup of 11, 12 or 13, the one-plus-one formula means that (including Commission, EFC and ECB participation) the number of participants in the meeting is around 30. If membership reaches 22 or 23, the number rises to 50; a *tour de table* that might have taken half an hour will become twice as long, consuming a much bigger proportion of a two or three hour meeting, unless some members forgo the opportunity to speak. If the result is to alter the subtle dynamics of debate, the value of peer pressure risks being diminished.

Many have argued that the external dimension of euro area governance is also unfinished business (Bini-Smaghi, 2006; Coeuré and Pisani-Ferry, 2007). There is still confusion, for example, despite what is written in the Treaty, about where power ultimately lies, in exchange rate arrangements. It is not obvious that enlargement of the euro area *per se* alters the picture, yet with the euro area unable to be a formal member of the IMF, co-ordination of euro area members' position is likely to become more pressing as the euro consolidates its role as the world's second currency. Yet the idea that the larger euro area members will readily give up their seats at the IMF in favour of a single euro area one still seems fanciful.

5 Revising governance arrangements

There are several potential ways forward for the governance of the euro area, turning on a number of strategic choices. These include: the degree of political choice (as opposed to rules) to be exercised in policy-making; innovation in, and reinforcement of, capacities to adjust to economic shocks and longer-run trends; and possible institutional development. It is also important to distinguish between what might be desirable economically, what can be done within the constraints of the Lisbon Treaty and what might reasonably be placed on the agenda for future treaty changes. Largely technical improvements can be separated from those that require difficult compromises.

5.1 Politicisation

EMU, to date, has been mainly a 'technical' project that has largely eschewed politicised decision-making, a facet of governance that may be unsustainable in the longer-term (Padoa-Schioppa, 2004). In contrast, national governments have to contend with heterogeneous backgrounds in terms of unemployment, inflation and wage bargaining systems, not to mention social policy priorities. Yet having very limited channels for political dialogue, debate about policy choices is stifled, as a result of which valid policy choices may not be put on the table. Only the Eurogroup, in practice, provides political input, prompting questions about whether, and if so how, the EMU governance system can be recast to offer more political choice.

There has been some debate about whether the answer lies in the Eurogroup acquiring power to legislate, and thus pre-empting some of what Ecofin does, but that would require Treaty change and would certainly be highly provocative for 'outs' and 'pre-ins', even if for the former group it could be presented as a corollary of remaining 'out'. Enhanced powers for the Eurogroup leading in the direction of *gouvernement économique* would also require a resolution of the French and German differences on how to run EMU. But with EMU close to entering adolescence, it is time for these to be settled.

However, the fact that the Eurogroup is only the finance ministry grouping is limiting. Even for the EU as a whole, the policy areas are balkanised, with the various committees mapping into their respective national ministries: the Economic and Financial Committee and the Economic Policy Committee corresponding to the macro and structural elements of finance ministries; the Employment Committee to labour ministries; and the Social Protection Committee to social security ministries. This structure tends to foment opposition between the

committees rather than common approaches. A basis for a new approach to governance may, therefore, be to have an overall body at euro area level – not necessarily composed exclusively of finance ministry representatives, but rather of ministers able to represent all relevant ministries - but to have sectoral euro area bodies that feed into the top-level committee.

One option would be to resort to an approximation to cabinet-style government in which there is an enhanced Eurogroup has its agenda prepared by the equivalent of cabinet committees, although an obvious problem would be that already over-stretched national ministers would simply lack the time to attend such sub-committees regularly. Widening the range of expert committees (instead of just the finance ministry-dominated EWG) that prepare the policy decision may be another option. National differences in how economic policy portfolios are assigned might present a problem, insofar as some countries have relatively limited mandates for the finance minister, possibly with a concentration on public finances, and give greater powers to an economy minister, while for others the finance ministry is the strategic player. Employment or science may be separated or lumped with either economy or economic development. In national administrations the solution is typically for there to be cabinet committees made-up of sectoral ministry representatives to prepare decisions for the full cabinet.

A difficult unresolved issue in economic governance in the EU and the euro area alike is how to align incentives so as to cajole Member States into 'responsible' behaviour. Is peer pressure enough and, even if it has been successful in the euro area so far, can it remain successful as the euro area enlarges? A possible answer would be to bolster peer pressure by enabling public pressure also to become a weapon. At a procedural level, the importance of dialogue in different areas deserves to be stressed. If, as is often suggested, fiscal and structural reforms are either facilitated or rewarded by more benign monetary conditions, it can be difficult to achieve when the strong independence of the ECB – sometimes portrayed as being on a pedestal on its own - appears to preclude 'bargaining' across policy areas. Dialogue in this area may therefore be an important tool and fostering bottom-up pressure may be more effective than an over-reliance on top down mechanisms.

A further political question is whether (or to what degree) additional forms of differentiated governance for the euro area, something that is bound to be contentious, but that also has a growing air of inevitability about it. Possible areas include prudential supervision, developing a distinctive euro area agenda for structural reform, or initiatives on the exchange rate. The evident sensitivity of the outs to separate formal structures has to be set against the need to reinforce, where appropriate, the governance arrangements for EMU. A credible way to do so would be to experiment within the confines of the Treaty, using some of the enabling clauses (for example in relation to prudential supervision). Longer-term, however, the challenges of governing a euro area that becomes more closely integrated as well as having many more members will need institutional deepening that it is difficult to see happening without further Treaty change. The sherpas and negotiators may cringe at the thought, but so be it.

5.2 Rethinking co-ordination

Further awkward questions re-casting policy co-ordination for a more diverse euro area, because policy mix will often be harder to optimise. National rules in fiscal policy may help to prevent excessive deficits and the still comparatively small economic weight of the CEEC-9 means that even if fiscal positions do diverge a bit, the overall compatibility with monetary policy will not be greatly undermined. But it is in the links between structural policy and monetary policy (and, to some degree, fiscal policy), that more imaginative solutions are needed. A fairly stark choice is which of rules, political discretion or independent technical oversight offers the most promising solutions. The answer is linked to the maturity and embeddedness of EMU. In the launch phase, rules played an important part in shaping the behaviour of policy actors, but may since have become less effective because they have been undermined.

Eichengreen (2007) has proposed reform of fiscal institutions so as to assure quality of public finances, with a focus on issues such as unfunded pension liabilities, too many publicly owned enterprises with soft budget constraints or fiscal arrangements at sub-national level that invite indiscipline. Another solution, which Wyplosz (2005) concedes could be a serious infringement on parliamentary sovereignty, is national fiscal policy councils with mandates on fiscal policy akin to that of monetary policy committees in independent central banks, that is assuring fiscal (that is public debt) sustainability. He answers the sovereignty concern by suggesting that the proposed committee should concern itself only with the budget balance, not its composition. However Steve Nickell, in his comment on Wyplosz (2006) is rather dismissive of the idea on the grounds that politicians will refuse to give up such powers.

Concerning fiscal co-ordination, the guarded conclusion of this essay is that because there is likely to be an enduring difference between the fast-growing and rapidly restructuring CEECs and the slower-growing core of the euro area, even the revised SGP will be problematic. Yet customised targets will be hard to manage and may undermine fiscal discipline. In these circumstances, looser rules aligned to some variant on a 'sustainability pact', as advocated by Coueré and Pisani-Ferry (2005), may be the best solution. To contain politically motivated slippage, especially around elections, Wyplosz's proposal for fiscal policy councils may have merit in bridging the gap between political and more technocratic approaches, perhaps complemented by independent forecasting to avoid gimmickry (Jonung and Larch, 2006). To forestall manipulation of fiscal indicators by national authorities, transparency in fiscal indicators could also be enhanced (for suggestions as to how, see: Koen and van den Noord, 2005; and Balassone et al., 2006).

There are even stronger analytic and political reasons for doubting, if not avoiding, a one-size-fits all policy framework for structural reform. Member States have to deal with their own, possibly idiosyncratic, reform imperatives, while concentrating at EU level on structural reforms needed to confront common challenges. This dichotomy can never be clearcut, but there is an evident difference between, say, reforms associated with countering climate change and action to improve the efficacy of a national employment service. Yet in political economy terms, an attraction of an organised process of co-ordination such as the Lisbon strategy is that it forces Member States to put policies in place.

5.3 Specific proposals

Numerous other proposals have been canvassed, some of which warrant consideration. There have been regular calls for the ECB to adopt full inflation forecast targeting, regarded by many as 'best practice' in monetary policy (for a dissenting view, see Buiter, 2006b) instead of the amended two pillar approach that it has followed since 2003. Pisani-Ferry et al. (2008) identify as a particular attraction that the improved transparency of a precise target would enhance credibility and facilitate communication. However, insofar as markets perceive the ECB already to be targeting 2% HICP it is open to question whether the change would make a great difference.

In monetary policy, a significant change in attitudes towards transparency has occurred over the last two decades, to the extent that a communication strategy is seen as a complementary instrument. In the post-2005 Lisbon strategy, ownership has been highlighted as a key governance aim, yet it is evident that success in promoting it has been limited. Nevertheless, the scope for increased transparency to be an instrument of economic policy in the euro area has not been sufficiently explored. It is, for example, suggested that transparency can help to boost the acceptability of fiscal consolidation and that governments which explain any deviation from a rule will also find it easier to secure public support (Guichard et al. 2007).

Rainy day funds have been tried in some Member States and may be a way of systematising a degree of fiscal discretion. The principle is very straightforward: governments build up the funds in good times and draw on them in bad times. But provided the funds in question have a neutral fiscal impact over the cycle, the risk of an incompatibility with monetary policy should be low. Indeed a rainy day fund would help to counter the pro-cyclical effects of the

SGP. Other ideas include the proposal to have a market for deficits within an overall euro area ceiling, allowing members to bid for bigger deficits (Casella, 1999) and even a fully fledged *European Republic* (Collignon, 2003), the essence of which is that a European government should take responsibility for the governance of European collective goods – defined in the widest sense and including macroeconomic management.

5.4 Concluding comment

Debate on the governance of EMU has been extensive, inconclusive and often divisive. As Pisani-Ferry (2006: 824) puts it, since the days of the Werner report 'advocates and opponents of economic policy co-ordination have been exchanging arguments in a never-ending controversy'. There is plainly a need for clarity and, ideally, greater simplicity in governance, as the Sapir report (2004) noted: 'the picture that emerges is one of confusion and tension – confusion created by the complexity of the system and diversity of the roles performed, tension in the gap between goals and means'. Yet it also has to be recognised that the EU and EMU are always going to be subject to complicated and messy political economy processes.

A summary verdict on the governance of EMU might be 'could do better, and will need to be improved to deal with enlargement of the euro area'.

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