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BEYOND THE ECONOMICS OF THE EURO

ANALYSING THE INSTITUTIONAL EVOLUTION OF EMU 1999-2010

by Marion Salines,
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ABSTRACT

This Occasional Paper examines how and why the institutional framework governing EMU has evolved since the creation of the euro. Building on theories of institutionalism, the paper in particular investigates to what extent functional spillovers from the single currency into other policy domains, like macroeconomic policies or financial regulation, met with an adequate institutional response, and to what extent the existing institutional framework conditioned the response to the financial crisis. The interaction between policy requirements and institutional capabilities is examined both in "ordinary times" (1999-2007) and under "crisis conditions" (2007-10). The paper uses a typology of change which helps to put into perspective both the resilience of the institutional framework of EMU and its capacity to adapt. In this respect, it allows for a better understanding and framing of the current reforms of EMU economic governance. It concludes that even though the crisis will accelerate institutional development, it will do so only gradually, as path dependence and an inbuilt bias towards incremental change will prevent policy-makers from pursuing a "clean slate" strategy.

JEL code: D79, E02, F02, F51, F53, F55, F59.

Keywords: EMU institutional architecture, historical institutionalism, rational choice, institutional change.

NON-TECHNICAL SUMMARY

This paper investigates the institutional dynamics of Economic and Monetary Union (EMU) since its inception in 1999. The analysis rests on the premise that "institutions matter", meaning that institutions played a key role in generating distinctive policy outcomes. A review of the first 12 years of EMU from an institutionalist perspective can help to explain more clearly the reasons behind the relative inertia and gradualism of the evolution of the governance framework for the euro. For the purposes of this paper, "institutions" are defined in a very broad sense and encompass formal and informal procedures, rules, interaction, etc. The paper aims to explore the following questions:

– Did the increased economic and financial interconnectedness between euro area countries as a result of the shared use of the single currency meet with an adequate institutional response in terms of common economic governance structures?

– What types of institutional change did we observe during the first decade of EMU?

– To what extent did the existing institutional structure condition the crisis response by the euro area/EU? In particular, did it succeed in mediating and shaping national interests to the benefit of the common interest of the euro area/EU as a whole?

– Can EMU's institutional structure be expected to change significantly and shift to a new development path as a result of the crisis experience?

While mainstream political economy approaches to EMU consider mostly new modes of governance (e.g. "soft" coordination, informal governance), this paper applies institutionalist theories, notably a typology of institutional change, to explain the role of institutions in generating the distinctive trajectory of EMU.

The interaction between policy requirements and institutional capabilities is examined both in "ordinary times" (1999-2007) and under "crisis conditions" (2007-10). As regards the first period, the paper analyses the incremental nature of the changes which the EMU framework has undergone using the concepts of layering and redirection, while at the same time capturing apparent insufficiencies to cope effectively with the new quality of economic interconnectedness across the Member States. In line with the predictions of institutionalism, the paper shows that the original institutional choices, notably the coexistence of a single monetary policy with decentralised economic policies, have largely determined the path of the institutional evolution over the first eight years. Even though common rules were not fully applied and enforced, the shortcomings of the initial design did not come to the fore during the first eight years of EMU, not least given the favourable economic conditions.

In "crisis times" (August 2007-September 2010), the paper focuses more specifically on the respective role of the EU institutions and the Member States' interests in shaping the crisis response. The rule-based system in place at the beginning of the crisis was not tailored for such extraordinary circumstances. However, the EU institutions did play a significant role in remedying the "collective action dilemma" and in shaping the Member States' behaviour during the first part (2007-09) of the financial crisis. In contrast, the sovereign debt crisis which erupted in 2010 has taken place in a context where decentralised policy-making, soft coordination and an insufficient enforcement of common rules could not fully prevent domestic interests from emerging.

The paper concludes that, even though the crisis will accelerate the institutional development of EMU (as witnessed by the creation of ESRB/ESFS and EFSM/EFSF), it will do so gradually, as path dependence and an inbuilt bias towards incremental change will prevent policy-makers from pursuing a "clean slate" strategy.

1 INTRODUCTION

Over the past 12 years, academics and policy-makers have significantly changed their perception and assessment of EMU, from initial scepticism and prudence during the launch of the single currency, where the euro was seen as a "high-stakes experiment" (Hodson 2010) whose "success could not be taken for granted" (Buti and Gaspar 2008), to widespread praise upon its 10th anniversary in 2009, when it was described as "spectacular" (Bergsten 2005: 28) and an "indisputable success" (Posen 2009: 85). However, with the onset of the sovereign debt crisis in 2010 the general perception shifted again rapidly from "where would we be without the euro?" (Martens and Zuleeg 2008) to "will EMU survive?". Many sceptical arguments about the feasibility of EMU were again brought to the forefront, with the voices of the "we-told-you-this-will-never-work" faction among commentators gaining important ground in the argument.[1]

Criticism of EMU in the first eight years had focused mainly on the comparably mediocre *economic* growth of the euro area overall while rarely commenting on the economic policy framework. During the crisis, in contrast, and especially with the onset of the sovereign debt crisis, the concerns of observers moved beyond economics, to also touch upon the *institutional* and *political* capacity of the euro area's governance framework to deal with the crisis and its implications.

EMU WITH A FUNDAMENTAL "DESIGN FAULT"?

At its core, the controversy revolves around the question of whether there was a fundamental "design fault" in the institutional setting of EMU. After all, the Maastricht Treaty embodied a conscious and fundamental political choice *not* to create a fully-fledged economic union to accompany monetary union, thus creating a fundamental asymmetry in the institutional structure. It thus differed markedly from the previous attempt to establish Economic and Monetary Union in Europe – the 1970 Werner plan – which foresaw, in addition to a federal central bank, a "centre of decision-making for economic policy" (Werner Report 1970: 12-13).[2] The Maastricht design for EMU conceived "around the green table" of the Delors Committee – naturally without any perfect foresight of the various challenges that could emerge in the practical operation of a monetary union – centralised monetary and exchange rate policy, but left fiscal policies, microeconomic, structural and prudential supervisory policies, as well as labour market and employment policies in the hands of national policy-makers, *"since there [were] – for the time being – no compelling arguments that could justify a full transfer of these policy responsibilities to the [Union] level"* (emphasis added, ECB 2001). Policy decentralisation was to endow national authorities with flexibility and vital room for manoeuvre and policy competition while preventing negative externalities through implicit coordination via rules for deficits and debt levels. The "no bail-out" clause (Art. 125 TFEU) was to instil market discipline on policy-makers through differentiated risk assessment and pricing in sovereign debt markets; the Stability and Growth Pact was to guide fiscal policy towards sustainability through a mixture of policy guidance, peer pressure and the threat of financial sanctions.

Yet already in the early years of EMU, prominent policy-makers such as Tommaso Padoa-Schioppa had argued that the asymmetrical nature of EMU must be transitory, and that another step forward must be made towards European integration.[3]

1 See, for example S. Brittan, 2010, "The futile effort to save the eurozone", Financial Times, 4 November ("If something is unsustainable, it will not be sustained"), or Christopher Smallwood, 2010, "Why the eurozone needs to break up", Capital Economics ("For the sake of the future economic health and success of the European Union, the eurozone needs to break up").

2 This centre of decision-making for economic policy was supposed to *"exercise independently, in accordance with the Community interest, a decisive influence over the general economic policy of the Community. In view of the fact that the role of the Community budget as an economic instrument will be insufficient, the Community's centre of decision must be in a position to influence the national budgets."*

3 See speech by L. Bini Smaghi at the inauguration of the Academic Year 2011, IMT, Lucca, 11 March 2011.

These dire warnings were brought into sharp focus by the financial, economic and sovereign debt crises, which have revealed fundamental market failures as well as blatant inadequacies in policy-making. However, the trajectory of EMU had been dictated by neither market forces nor the fruit of mere coincidence from accumulated bad policies.

Based on the premise that "institutions matter", this paper reviews the first 12 years of EMU from an institutionalist perspective with a view to identifying the reasons behind the relative inertia and gradualism of the evolution of the governance framework for the euro. For the purposes of the analysis, we distinguish between the performance of EMU in "ordinary" or "fair-weather" times (1999-2007) and under "crisis conditions" (August 2007 to September 2010). The analysis covers the period until September 2010 (publication of Commission proposals for economic governance). While a number of momentous economic and institutional developments have happened since then, we define this, somewhat arbitrary, cut-off date to maintain a clear focus for the analysis. References to specific developments since that cut-off date are included where this adds value to the arguments presented.

With regard to the "fair-weather" period, i.e. the extraordinary period of low macroeconomic volatility in the early years of the euro, we aim to explore the following questions:

– Did the increased economic and financial interconnectedness deriving from the shared use of the single currency meet with an adequate institutional response from the economic governance framework?

– What types of institutional change did we observe?

– To what extent did previous institutional choices determine the path of the institutional evolution?

– How to explain this distinctive trajectory?

The crisis period since 2007 put severe pressure on the operation of the institutional framework, motivating a different set of questions, namely:

– To what extent did the existing institutional structure condition the crisis response within the euro area and at the EU level?

– Did it succeed in mediating and shaping national interests to the benefit of the common European interest?

– Will the crisis experience lead to a fundamental reform of EMU's institutional structure and shift to a new development path?

In seeking to answer these questions, the paper is structured as follows. Section 2 sets out the conceptual framework applied throughout the paper. Section 3 explores the evolution of the EMU framework in "ordinary times" (1999-2007), while Section 4 analyses the reaction of EMU to the crisis during "extraordinary times" (2007-10). Section 5 attempts to draw some lessons from the first 12 years of EMU and discusses the likely evolution of the EMU institutional framework after the crisis.

2 INSTITUTIONS MATTER: EXPLAINING THE EVOLUTION OF EMU THROUGH THE INSTITUTIONALIST LENS

2.1 DEFINITIONS AND METHODOLOGY

Since the inception of the euro, the institutional architecture of EMU has displayed both continuity and change. For the purposes of this paper, "institutions" are understood in a very broad sense and encompass formal and informal procedures, rules, interaction, etc. In fact, institutions can be compared to biological entities that are "not perfectly designed organisms" but are constantly adapting and evolving, thus producing variation, incremental changes or ruptures at critical junctures (Steinmo and Lewis 2007).

How can we account for the changes observed and their impact on the economic governance of EMU? Classical economics alone cannot fully explain them. Even if economic reasons were the trigger for change, they alone cannot account for the particular form of institutional change that occurred. Why did some institutions fare better than others in the EMU framework? Why did new institutions emerge while others became marginalised? North and Weingast (1989) gave an important example of how institutions impact on the economy with their study of the Glorious Revolution, thereby complementing and expanding a perspective based purely on the uncritical acceptance of neoclassical economics. For *"neoclassical theory is concerned with the allocation of resources at a moment of time, a devastatingly limiting feature to historians whose central question is to account for change over time. Moreover, the allocation was assumed to occur in a frictionless world, that is, one in which institutions either did not exist or did not matter"* (North 1990: 131).

On the other hand, mainstream political economy approaches to EMU have also been partial, and have not really undertaken a comprehensive examination of the whole institutional structure.[4] They have proved to be static and have neither captured nor explained institutional change or the lack thereof.[5] This is what this paper aims to achieve with the analytical tools provided by the new institutionalist approach.

2.2 THE NEW INSTITUTIONALIST APPROACH

In political science, this new theoretical approach emerged in the 1980s partly as a reaction against behavioural perspectives. Its main assertion is that institutions do matter in determining decisional outcomes (Nugent 2006: 572). An institutionalist perspective can help forge a better understanding of both the resilience and the degree of adaptability of EMU's institutional architecture. It looks at the institutional organisation of the polity or political economy as the main factor structuring collective behaviour and generating distinctive outcomes (Hall and Taylor: 937). It can measure "big structures, large processes and [make] huge comparisons" (Tilly 1984)[6], based on the key assumption that institutional development is dominated by path dependence. *"Once actors have ventured far down a particular path, they are likely to find it very difficult to revert course. The path not taken or the political alternatives that were once quite plausible may become irreversibly lost. 'Path dependence analysis' highlights the role of 'historical causation' in which dynamics triggered by an event or a process at one point in time reproduce themselves, even in the absence of the recurrence of the original event or process"* (Pierson and Skocpol 2002).

The institutionalist approach can offer useful insights to elucidate the institutional trajectory of EMU from 1999 to 2007.

4 For an early critique of the governance approach, see Dyson (2000: 106-108).

5 For a balanced and nuanced account of the strengths and weaknesses of the "principal-agent" approach as applied to EMU governance, see Hodson (2009b).

6 Big structures, large processes and huge comparisons, Tilly, 1984.

Institutionalism[7] is also "fit for purpose" to explore the policy response to the crisis (2007-10), as another strand of the new institutionalism investigates the extent to which, and the ways in which, institutions shape, channel and constrain the rational choices of political actors (Nugent 2006: 573). Applied to the process of European integration, this approach can explain the motivations of national governments to engage in the process of European unification despite the implied loss of competences, i.e. the shifting boundaries of national sovereignty (Nugent 2006: 573). It is based on three main assumptions (Hall and Taylor 1996: 944-945). First, as in microeconomic rational choice theory, actors have a fixed set of preferences and behave rationally so as to maximise their utility. Second, politics is a series of "collective action dilemmas": with each political actor intervening to maximise the attainment of its own preferences, the outcome is likely to be collectively sub-optimal. Third, institutional arrangements can offer a remedy to this problem by influencing actors' behaviour, notably by shaping their expectations about how others are likely to behave and, in this way, to influence their strategic calculations.

The crisis has led to a multiplication of "collective action dilemmas" in EMU, because a more robust pursuit of the national interest usually comes to the fore in times of crisis. This is because *"in difficult economic times the comfortable illusion [that the economy works with sufficient regularity] disintegrates, […] economic models come into conflict, and policy prescriptions diverge"* (Gourevitch, 1986).[8] By looking at the "crisis times" through the lens of institutionalism, the paper will seek to explain patterns of policy response and the resulting outcomes.

2.3 A TYPOLOGY OF INSTITUTIONAL CHANGE APPLIED TO EMU

Precisely because "institutions matter" – particularly their relative inertia or adaptation – in explaining the evolution of EMU, it is useful to develop a more detailed typology of institutional change to better describe the developments of the "institutional ecosystem" observed over the past decade. The paper will thus draw on the following typology developed by Streeck and Thelen (2005) and Mahoney and Thelen (2010):

- ***layering*** is an institutional change which happens when new institutional elements are added to existing ones. Applied to the context of EMU, this process can be seen in the successive addition of institutions (such as the EFSM/EFSF or the "codification" of the Eurogroup in the Lisbon Treaty), processes (creation of the Lisbon agenda and related process) and policy instruments (Art. 136 TFEU decision addressed to Greece);

- ***displacement*** takes place when an element of the institutional structure becomes more salient over time. The ECB provides an interesting instance of "displacement": the ECB's role has been more and more prominent since the outbreak of the crisis, first with measures on the financial markets in August 2007, then with the Securities Market Programme (SMP) to ensure a proper transmission of monetary policy during the sovereign debt crisis and a strong voice in the debate on governance reform;

- ***redirection*** occurs when an institution has its parameters changed and its objectives reorientated, be it in a fundamental way or in a marginal manner. One example of such a change is the Stability and Growth

7 As explained by Hall and Taylor (1996), so-called rational choice institutionalism originated in the observation of a paradox in the political behaviour of the US Congress. The traditional "rational choices" approach would lead to the conclusion that it is virtually impossible to secure stable majorities for passing legislation in the House of Representatives and the Senate. However, Congressional outcomes actually show considerable stability. To explain this paradox, rational choice institutionalists turned their attention to institutions and demonstrated how the rules of Congress affect the behaviour of legislators, reduce the transaction costs and solve many of the collective action problems with which a parliament is usually confronted.

8 For a historical overview of politics during economic crises, see Gourevitch (1986).

Table 1 Varieties of gradual change [1]

	Layering	Displacement	Redirection	Drift	Depletion
Definition	New elements added to existing frameworks slowly change their structure	Some institutions gain more salience over time	Old institutions get new objectives on top of their old ones	Institutions adapt insufficiently to external change	Institutions wither away
Drivers of stability/ change	Pressure for change accommodated by small on-path changes			Lack of actor interest in change; important switching costs	Failure of reproduction mechanisms
Example in EMU	Eurogroup "codification" in the Lisbon Treaty; EFSF; ESRB; Extension of surveillance mechanisms	ECB took the "lead" during the crisis as crisis "manager": providing liquidity, SMP	SGP and budgetary surveillance redirected towards sustainability and set to take imbalances into account	Financial supervision; Lamfalussy process; competitiveness framework	None

1) Adapted from Streeck and Thelen (2005: 31).

Pact which has gone beyond being a mere disciplinarian device (limiting the borrowing of the Member States to ensure the sustainability of EMU and to prevent harmful spillover between the Member States and between fiscal and monetary policy) to become a more wide-ranging instrument designed to steer broader aspects of budgetary policy (increasing its focus on the long-term sustainability of public finance and pensions, as well as on the quality of public finances and domestic institutional frameworks, like rules or medium-term frameworks);

- ***drift*** happens when institutional structures are overwhelmed by external developments. Such a case can be found in the discrepancy between financial integration, which proceeded apace, and the elaboration of financial supervision, which remained fragmented;

- ***depletion*** can be identified when institutions experience a gradual breakdown over time. Clearly, this variety of gradual change hardly applies to EMU since it is still a relatively young "institution".

This typology of institutional change needs to be complemented by a review of the drivers of institutional change. While the mainstream literature usually focuses exclusively on path dependence, overstating permanence and then being unable to explain change, Lindner (2003) reverses the argument by focusing on what produces institutional stability. The analysis of institutional *stability* provides the key to explaining the emergence of institutional change. There are four "reproduction mechanisms": the bargaining power of the anti-change coalition; the interdependence between policy sub-fields; the costs of switching to another institutional setting; and the ability to accommodate pressure for change through minor adaptations. Institutional change comes about only when these reproduction mechanisms break down.

3 PLAIN SAILING? EMU IN FAIR-WEATHER TIMES (1999-2007)

This Section identifies and examines the varieties of institutional change to the EMU framework in "fair-weather times", clustered into two groups: the first, which reflects the concept of spillover effects through layering and redirection, represents the slow and incremental adaptation of the institutional architecture of EMU to internal and external pressures like the Stability and Growth Pact (SGP) crisis of 2003-05. The second, embodied by the logic of resistance and path dependence, shows how institutions faced difficulties to adapt because of the long-lasting and locked-in effects of the institutional choices made in Maastricht. In addition to these institutional changes, the degree to which inherent tensions come to the fore also depends on the economic conditions. The structural flaws of the EMU framework analysed below did not materialise in the period 1999-2007 largely because of the extraordinary macroeconomic stability and a relative absence of severe market volatility.

3.1 HOW EMU INSTITUTIONAL ARCHITECTURE ADAPTED INCREMENTALLY: LAYERING AND REDIRECTION

Since the Maastricht Treaty, the institutional architecture of EMU has evolved mainly on account of the process of *layering* and *redirection*, owing to institutional frictions and spillover effects stemming from the asymmetrical structure of EMU. This has resulted in continued efforts over time to put more flesh on the "E" of "EMU" even before EMU became a reality. In the words of the Delors report, this is because "*Economic and Monetary Union form two integral parts of a single whole and would therefore have to be implemented in parallel*".[9]

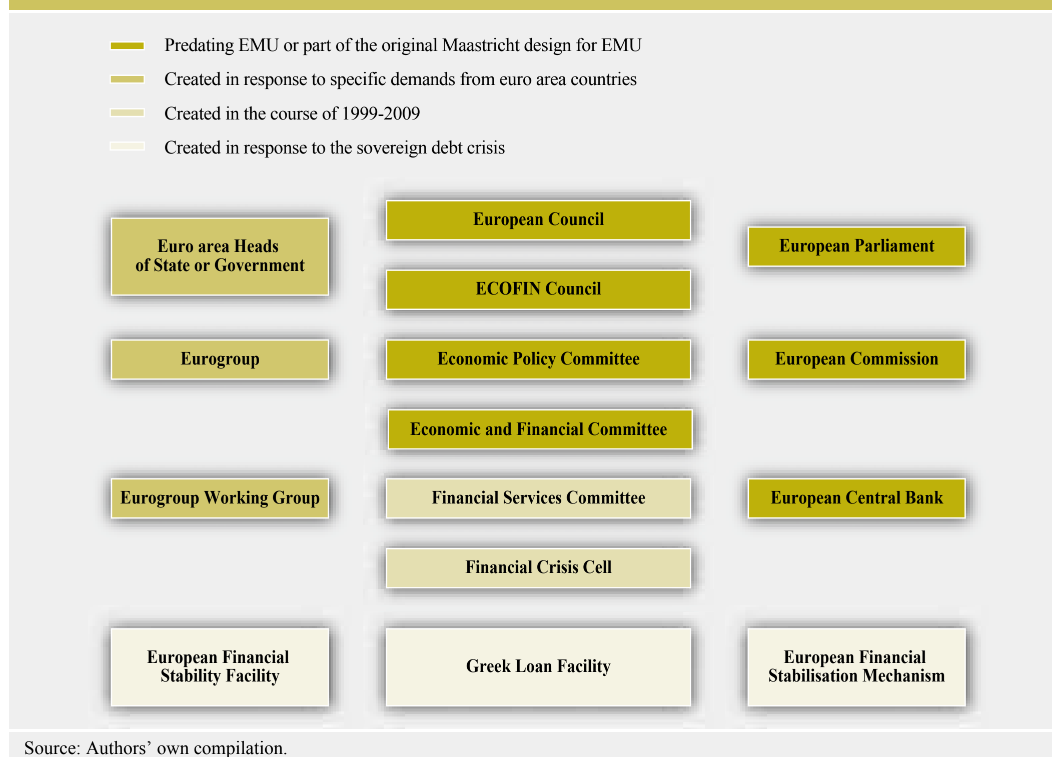
A first step was taken to reinforce economic governance with the creation of the SGP, signed in 1997. It was designed to build on and clarify a framework for sound budgetary policies and to avoid free-riding. It was also useful in terms of clarifying the Excessive Deficit Procedure of Article 126 of the TFEU. On top of this came the Eurogroup, which provides an informal forum for finance ministers from the euro area (see Puetter 2006).

Simultaneous steps were taken to reinforce the coordination of structural economic reforms on the supply side. Yet, while the SGP was mainly based on "hard coordination" through "hard law", structural coordination was "soft" because it relied on a new institutional layer dubbed the "Open Method of Coordination" (OMC). Contrary to the traditional "Community/Union method" which relies on the Commission as agenda-setter, voting by the Council and the European Parliament and the interpretation of law by the European Court of Justice, the OMC is a *"heterarchical, decentred and dynamic process [which] supports and radicalises the principle of subsidiarity"* (Hodson and Maher 2001: 719). The coordination of structural reforms is important because of potential spillovers that can happen between these policy areas and the fiscal and monetary domains. Thus, economic spillovers can become political spillovers in the form of new institutional *processes*. The coordination of these reforms was supposed to be achieved through *processes* like those of Luxembourg (1997 – labour market reforms), Cardiff (1998 – product and capital market reforms) and Cologne (1999 – macroeconomic dialogue involving social partners). These processes were streamlined in the Lisbon Strategy of 2000 which established goals for the creation "of the most competitive economy in the world" by 2010. This process was reformed in 2005 and further refined in 2010 with the Europe 2020 strategy.

This process of institutional layering of economic governance came on top of the Broad Economic Policy Guidelines (BEPGs). The BEPGs have been around as such since 1993, but date right back to the Treaty of Rome and the time when the Monetary Committee started

9 Delors Report, 1989: paragraph 21.

Chart 1 Institutions and bodies within EU/euro area economic governance



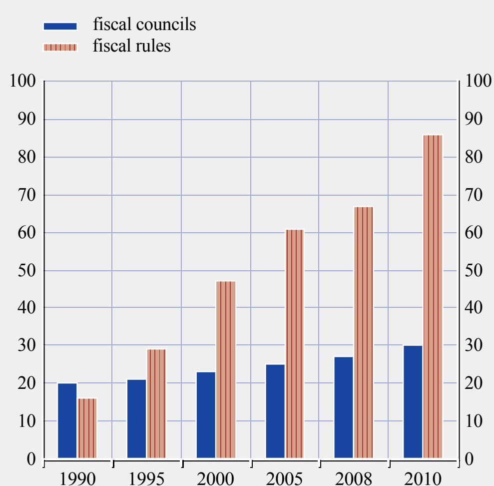
Source: Authors' own compilation.

to publish country recommendations in 1959 (see Deroose, Hodson and Kuhlmann 2008). The BEPGs also represent a form of path dependence: the creation of a Medium-Term Economic Policy Committee in 1964 issued guidelines which also later became the main instrument used to coordinate economic policies in order to implement EMU (article 99.2 of the Maastricht Treaty). In fact, the first BEPGs of 1993 were the core of a nascent multilateral surveillance, a framework to assess the Member States' convergence programmes towards EMU and a way for the Member States to commit to EU economic policy objectives.

Any description of institutional change to the economic governance framework of EMU would be incomplete without looking at the diverse processes of policy learning, policy transfer and institutional transplants which round off the layering process of the governance framework of EMU at the domestic level. A key process which is taking place concerns the reform of national fiscal frameworks to internalise the necessities of participating in EMU at the domestic level. A key policy learning process and institutional transplant should be identifiable in the case of debt rules and the constitutionalisation of budgetary balance. In the midst of the crisis Germany tightened the "debt brake" which limits net borrowing by the Federation and the *Länder* and also aims to cut the structural deficit to 0.35% of GDP by 2016 (Kastrop et al. 2009). This reformed German rule sparked a heated debate in France where comparable proposals were tabled (Delpla 2010 and Bouzou 2010). This specific example of policy learning occurs in the broader context of the open method of coordination where benchmarking, consensus and exchange of policy experiences come to the forefront: what is discernible is in fact the process of trial and error where observations from policy successes and failures lead to

Chart 2 Evolution of domestic fiscal governance in the EU

(in absolute numbers)



Sources: European Commission, Fiscal Governance Database.

consensus formation and policy emulation (e.g. "Danish flexicurity").[10]

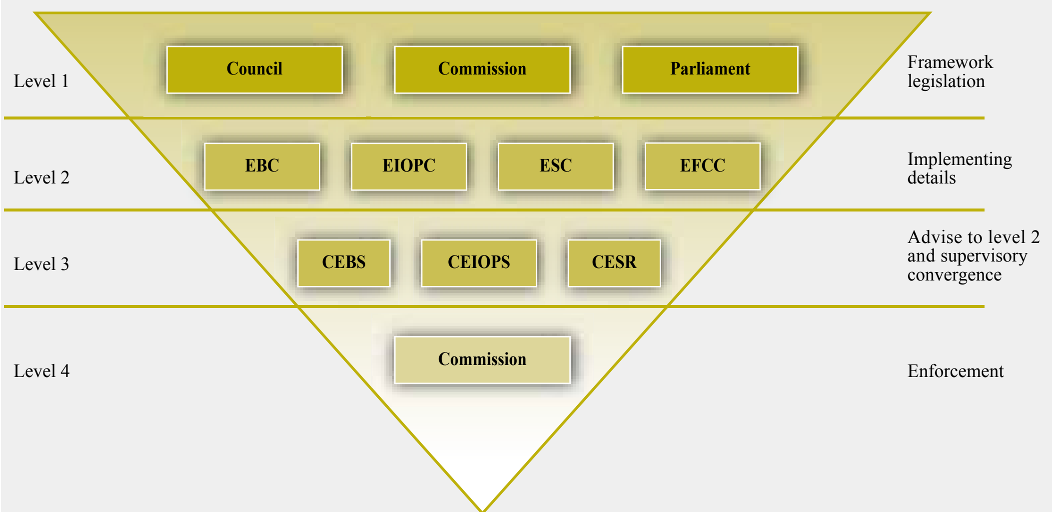
This latter example of fiscal governance provides a useful insight into *institutional redirection.* The original SGP was a disciplinary mechanism intended to prevent over-expansionary fiscal policies on the one hand while coordinating national budgets on the other. Yet the SGP reform of 2005 and subsequent developments redirected its logic in two ways. First, it extended budgetary surveillance horizontally by focusing more on the long-term perspective and on fiscal "sustainability": the debt criterion becomes more important than the deficit, and more attention is paid to pension systems and implicit liabilities (see European Commission 2006a: 126). Second, it extended budgetary surveillance vertically by looking at the composition of public expenditure in the Member States' budgets and by fine-tuning the SGP to national conditions with country-specific medium-term objectives (Schelkle 2009). It also shifted from a mere implementation of the SGP as a supranational process to a focus on strong national fiscal frameworks and national ownership of European objectives. Hence the three new agendas of budgetary surveillance which emerged step by step: reports on fiscal sustainability in 2006 and 2009 investigating long-term expenses related to pensions systems (European Commission 2009d); the focus on the "quality of public finance" (Schaechter and Barrios 2008); and the analysis of the political economy of domestic fiscal regimes and their efficiency (European Commission 2006 and the subsequent yearly *Public Finance Reports* of the Commission). The results of this work show that domestic fiscal regimes have been strengthened over time, notably by a more widespread use of fiscal rules. This last point can be measured using the fiscal rules index contained in the Fiscal Governance Database of the European Commission (see Chart 2).

In the same vein, the evolution of financial supervision in the EU embodies a layering process: *"The Lamfalussy architecture is articulated across multiple institutional levels. At level 1, the EP and the Council co-decide framework legislation (directives) proposed by the Commission. At level 2, the implementing measures (generally directives, less frequently regulations) of the level 1 framework legislation are adopted by the Commission through the comitology process, which involves the so-called level 2 committees of Member State representatives. At level 3, the committees of national regulators (level 3 committees) advise the Commission on the adoption of level 1 and level 2 measures and adopt level 3 measures, such as non-legally binding standards and guidelines"* (Quaglia 2008: 564).

10 In fact, this process of policy learning is supported by the increasing importance of databases and more effective methodologies of surveillance (Deroose, Hodson and Kuhlmann 2008). Since 2005, EU LABREF aims at gathering information on labour market reforms in the EU Member States (employment protection legislation, unemployment and welfare benefits, active labour market programmes and labour taxation). Since 2007, EU KLEMS has made it possible to consult data on productivity development at the industry level for the Member States since the 1970s (Koszerek et al. 2007). The LIME Working Group of the Economic Policy Committee, which involves Commission and national officials, works on developing methods to measure the progress of structural reforms. The most recent database concerns national fiscal frameworks. Established in late 2009, it provides useful information on fiscal rules, independent fiscal institutions and medium budgetary frameworks in the EU Member States. It draws on yearly questionnaires sent to national finance ministries which specify further the institutional characteristics of their national fiscal frameworks.

Chart 3 The Lamfalussy structure of supervisory committees in the EU[1]

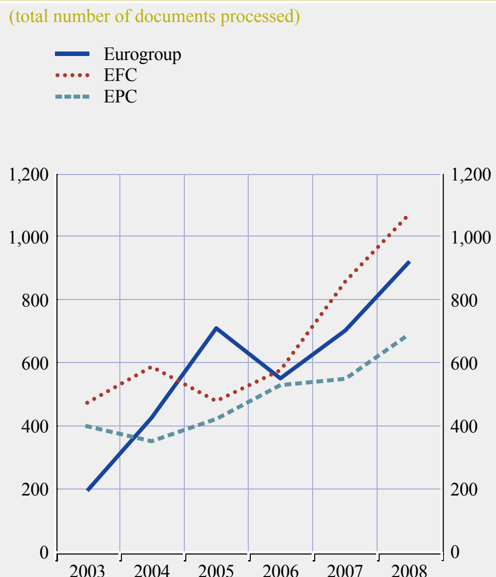
EBC = European Banking Committee
EIOPC = European Insurance and Occupational Pension Committee
ESC = European Securities Committee
EFCC = European Financial Conglomerates Committee
CEBS = Committee of European Banking Supervisors
CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors
CESR= Committee of European Securities Regulators



Source:
1) Adapted from De Haan, J., Oosterloo, S. and Schoenmaker, D., (2009), p. 54.

Chart 4 Evolution of the amount of documentation dealt with by selected EU bodies (2003-2008)

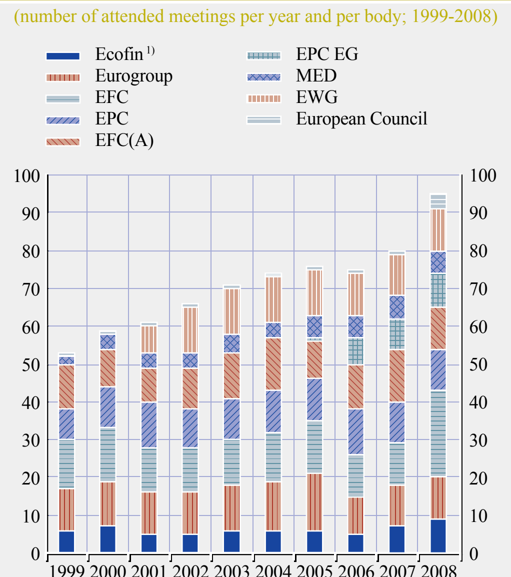
(total number of documents processed)



Source: ECB.

Chart 5 Evolution of the number of meetings attended by ECB representatives

(number of attended meetings per year and per body; 1999-2008)

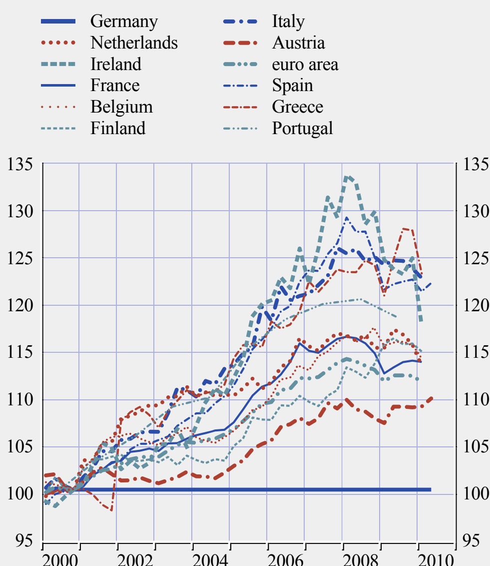


Source: ECB.

Finally, this process of institutional layering and redirection is also embodied within inter-institutional relations. EMU governance went through a process of ever denser interaction which can be broken down into four trends: *(1)* an increased frequency of interaction; *(2)* a broadening of the topics discussed within economic fora; *(3)* a deepening of the discussions with an increase in ECB written contributions; and *(4)* more areas of discussion (European Central Bank 2010a and Charts 4 and 5).

Chart 6 Evolution of unit labour costs across the euro area

(index 2000Q4 = 100; relative to Germany; based on s.a. data)



Source: Eurostat. Quarterly data up to 2010Q1; 2010Q2 for AT, DE and ES; PT is based on annual data (up to 2009).
Note: The ULC indices are set to 100 in the last quarter before the euro area accession of Greece. The ULC developments presented for Greece and Portugal might differ from the calculations made by the national central banks. The quarterly pattern in Greek ULC is affected by substantial volatility in quarterly compensation of employees figures.

3.2 ACCOUNTING FOR THE PATH DEPENDENCE OF EMU'S INSTITUTIONAL ARCHITECTURE

While a gradual adaptation of the institutional framework is discernible, notably in response to functional spillover effects, there is also evidence of resistance, stickiness and path dependence within the architecture of EMU. In other words, the institutional framework did not adapt sufficiently to the increased level of interconnectedness within the euro area. The fact that the observed institutional layering took place thus reveals certain shortcomings in the initial design of EMU. However, the incremental changes were not sufficient to address the fundamental mismatch between the degree of policy interconnectedness and institutional evolution. While euro area economies become ever more interlinked, the institutional structure did not provide euro area countries with the right incentives, be it sanctions or rewards, to internalise the constraints of monetary union.

For instance, despite the institutional layering observed in fiscal and macroeconomic surveillance, the framework was unable to correct diverging competitiveness developments across the euro area and the deterioration of public finances in some countries. Hence, while institutional layering proves the institutional resilience of the EMU framework, it also sheds light on one shortcoming: its insufficient capacity to adjust swiftly and optimally to exogenous shocks and to enforce credibly the rules on which it is founded. Cases in point are the BEPGs, which failed to stem the diverging competitiveness developments within the euro area (see Chart 6), and the SGP, which did not force the Member States to maintain their national budgets "close to balance or in surplus".

Another telling example of path dependence, resistance and institutional friction is to be found in the governance of financial markets in the euro area. In fact, market integration has outpaced institutional integration. Alexandre Lamfalussy, the former head of the European Monetary Institute, qualified financial governance as "sub-optimal" (Lamfalussy 2004). This created institutional friction as EU financial integration stumbled upon what can be called a "financial stability trilemma": there is an inbuilt incompatibility between financial integration, financial stability and independent national supervision (Schoenmaker and Osterloo 2007). Institutional friction also stems from the fact that *"the home country supervisors' mandate does not include co-responsibility for financial stability in*

partner countries, but the host country authorities, whose mandate is to ensure financial stability, do not have authority for supervising financial institutions from partner countries unless they operate through independent subsidiaries" (Pisani-Ferry and Sapir 2010: 345).

As long as banks remained in the national realm, national regulators had an informational competitive advantage and thus blocked any transfer of competence to the EU. But while the emergence of pan-European banks made this argument less stringent, there were no supervisory arrangements which would give more power to the EU level. Instead, the institutional dynamics of financial supervision have followed more the logic of decentralisation over to national regulators, the harmonisation of EU legislation, and the creation of a European Committee of Banking Supervisors (CEBS) to ensure consultation between national regulators and technical advice to the Commission (Quaglia 2010).

All this demonstrates that the institutional choices made in Maastricht have largely determined the path of the institutional evolution of EMU over the first eight years. In fact, the Lisbon Treaty did not fundamentally reform EMU (see Box 1) despite the fact that, as the successor to the late Constitutional Treaty, it was supposed to address concerns over economic governance expressed in the Laeken Declaration of the European Council in 2001.

Box 1

THE LISBON TREATY AND EMU – INCREMENTALISM ON PARADE?

The Lisbon Treaty does not fundamentally change the institutional structure of EMU as laid down by the Maastricht Treaty, but introduces some changes aimed at consolidating monetary union and provides opportunities to further enhance economic governance (ECB (2010) and Frankal, Oleaga and Coussens (2007)). From this vantage point, those changes at the margins embody what institutionalist literature calls "incrementalism". In fact, the Lisbon Treaty did little more than codify the evolution and the trends already observed during the first ten years of EMU.

In terms of monetary union, the ECB, initially a sui generis institution, keeps its core features (independence, legal personality, regulatory powers) and becomes a "Union institution", which implies that provisions common to all institutions apply to the ECB. The Lisbon Treaty extends the general public access regime to all institutions and bodies (common obligation to conduct work "as openly as possible"). The appointment procedure for Executive Board members now relies on majority voting rather than common accord between national governments, which brings the procedure into line with those for other key EU nominations.

The mandate of the ECB is reasserted, monetary policy is explicitly noted as an EU competence, and price stability is elevated from an ESCB objective to an objective of the EU as a whole. The "Eurosystem" is mentioned for the first time in the Treaties. "EMU whose currency is the euro" is worded as an EU objective. The enlargement of the euro area will still be decided by the full EU Council, but it will have to take into account the view of euro area members.

In terms of economic governance, the role of euro area members is strengthened. A new provision allows them, by qualified majority, to adopt new measures to bolster the coordination and surveillance of their budgetary discipline and to set out specific economic policy guidelines for euro area members. The Eurogroup is recognised in the Treaties for the first time while

retaining its informal status (i.e. no formal decision-making powers). Its president will serve a term of two-and-a-half years (instead of the previous two-year term). The European Commission sees its role enhanced in economic surveillance both in the BEPGs and the EDP: for instance, the Commission can directly address an opinion to a non-compliant Member State. At the subsequent stage of the procedure, where the ECOFIN Council steps in, the Member State concerned is barred from voting.

As regards the external representation of the euro area, although the Lisbon Treaty does not fundamentally alter the current arrangement, it does clarify and improve it. As is currently the case, the euro area countries can decide, by qualified majority, to mandate a particular body or person to represent the euro area in a unified way in international fora. The Lisbon Treaty explicitly provides for the EU Council to have the means at its disposal to take "appropriate measures to ensure unified representation".

This lack of profound institutional change can be explained by the weight of two "reproduction mechanisms" (Lindner 2003), namely the lack of interest in change among the dominating actors and – paradoxically – the ability of the institutional structure to accommodate pressure for change through small institutional alterations at its margins.

The former was exemplified during the negotiations of the new treaties: the late Constitutional Treaty and the now implemented Lisbon Treaty (Hodson 2009a: 520). First, finance ministers opposed any radical change to the institutional architecture of EMU, unwilling as they were to upgrade the Eurogroup to the full status of a Council formation or to give more power to the European Commission (Puetter 2007). Second, tensions between France and Germany over a potential political counterweight to the ECB reduced the chances of an overhaul of economic governance in the first decade of EMU. Finally, the timing may also have raised some hurdles: the Working Group on Economic Governance of the European Convention "*met during a period of heightened tension over the enforcement of the Stability and Growth Pact*" (Hodson 2009a: 520). In July 2003, the European Convention presented its draft Constitution. The Intergovernmental Conference (IGC) did so for the final draft in June 2004. This overlapped with the vote to put the SGP "in abeyance" in November 2003 and the ruling of the European Court of Justice in July 2004. In fact, *"there was little appetite among the members of the European Convention's Working Group on Economic Governance to become embroiled in the controversy over the Stability and Growth Pact by calling for radical reforms to EMU's institutional architecture"* (Hodson 2009a: 520).

Most importantly, the relative stability of EMU over its first eight years can be explained by the ability of the institutional framework to accommodate pressure for change via small on-path changes (as described in Section 3.1). A number of incremental changes took place to address the increased economic and political interconnectedness between euro area economies, but they did not go far enough to cope fully with it and paradoxically contributed to the stickiness of the institutional framework. Plus of course, favourable economic conditions, notably the "goldilocks economy" of moderate growth and an environment of price stability, played a significant part in avoiding any manifestation of the consequences of the mismatch between policy requirements and institutional capabilities.

The period of crisis, in contrast, may have proved to be a shot across the bows by revealing the shortcomings of EMU's institutional framework. In the next Section, the focus of our analysis will move from institutional change per se to how the institutional framework structured – and thus, to a certain extent, conditioned – the crisis response.

4 WEATHERING THE STORM: EMU DURING THE CRISIS (2007-10)

The financial turmoil that started in August 2007 has been largely recognised by observers as a turning point and litmus test for EMU. For the first time since its launch, the ability of EMU to mount a swift and coordinated response to external shocks has been stress-tested on a massive scale. This has presented a whole new set of challenges to EMU and its institutional structure. The next Section attempts to capture the dynamics of EMU between 2007 and 2010 by taking a micro-approach and focusing more specifically on the respective role of the institutions and of Member States' interests in shaping the crisis response. The subsequent Sections will analyse in turn the response of EMU to the financial crisis (Section 4.1) and to the sovereign debt crisis (Section 4.2).

4.1 POLICY COORDINATION INITIATIVES DURING THE FINANCIAL CRISIS

The situation in which the EU has found itself since the outbreak of the crisis has been characterised by numerous (positive and negative) spillover effects from national policy actions into areas such as liquidity support, recapitalisation of banks and fiscal policy (Quaglia, Eastwood and Holmes 2009: 67). The EU has traditionally been based on a set of rules (e.g. competition policy), compliance with which is ensured by the Commission and the ECJ. However, the rule-based system in place at the beginning of the crisis was not tailored for such extraordinary circumstances. The coordination by the EU of national responses to the crisis could not revert to rules, and some discretionary action was thus required. This could have implied a severe risk of a vicious spiral of "beggar-thy-neighbour" policies like in the 1930s[11] – something which the EU has successfully mitigated.

This is amply illustrated by the Irish example (Glöckler 2009). Shortly after the collapse of Lehman Brothers, the Irish government announced a guarantee that would "*safeguard all deposits, covered bonds, senior debt and dated subordinated debt*" (Irish Ministry of Finance 2008) with six Irish financial institutions. This decision was aimed at avoiding bank runs and a meltdown in the domestic financial sector and was thus fully rational from an Irish political perspective. However, it ignored the potential "externalities" of this decision, notably the fact that Ireland, and the Irish financial system, are part of the euro area and EU financial market. If other EU countries had attempted to "maximise their utility" by announcing measures of that type, it would have led to a fragmentation of the integrated financial and money markets: savers would naturally have withdrawn their savings from banks in countries where these were not guaranteed by the State and channelled them to banks in countries where they were. Had this spiral of financial sector "beggar-thy-neighbour" measures escalated, the integrated financial market would have refragmented and renationalised into individual national financial markets. The outcome would have been clearly sub-optimal from a pan-European perspective.

The swift reaction of EU institutions contributed to remedying this problem – albeit only partially. On 7 October 2008 the ECOFIN Council committed to take all necessary measures to protect the deposits of individual savers (EU Council 2008). A week later, the European Commission (2008d) brought forward a proposal to promote convergence of deposit guarantee schemes. It was aimed at avoiding competitive distortions, inter alia, by increasing the minimum coverage level, and was adopted in March 2009. Nevertheless, this revised directive was not without limitations since it set a minimum, not a maximum, for such schemes in the Member States. In addition, it did not regulate guarantees in respect of non-deposit liabilities (Quaglia, Eastwood and Holmes 2009: 76).

11 Involving, inter alia, unilateral devaluations and the reintroduction of import levies.

A number of similar initiatives have been taken at the EU level to ensure that the design of national stabilisation measures to resolve the financial turmoil does not lead to negative spillover effects and that a level playing field is maintained across the EU (see Box 2).

Box 2

POLICY COORDINATION MEASURES IN SUPPORT OF THE FINANCIAL SECTOR DURING THE CRISIS[1]

At the euro area summit in Paris on 12 October 2008, the euro area countries adopted a concerted action plan with the aim of restoring confidence in the markets and promoting the proper functioning of the financial system. The plan consisted of a euro area umbrella of guiding principles and common intentions for the design of national responses with a view to upholding the common market. It entailed four main points: (i) harmonising the provision of retail deposit insurance; (ii) issuing government guarantees for bank debt securities; (iii) making funds available for bank recapitalisations; and (iv) providing asset relief measures. A few days later, on 15 and 16 October, the European Council endorsed the principles laid down in the Paris Declaration as applying to the single financial market in the EU.

In close cooperation with the ECB, the European Commission has provided guidance to the Member States on the implementation of these common principles. In its "Banking Communication" issued in October 2008 (European Commission 2008c), it provided a framework for Commission approvals of State aid schemes and ad hoc rescue measures for banks. It allowed for a tailor-made application of State aid rules given the exceptional circumstances, while attempting to limit distortions of competition in the Single Market. In December 2008, the Commission also adopted a Communication on the recapitalisation of financial institutions (European Commission 2008f). With a view to complementing the Commission initiatives, the ECB Governing Council issued recommendations on government guarantees for bank debts (European Central Bank 2008c) and on the pricing of bank recapitalisations (2008d). It also drew up guiding principles for bank asset support measures.

In February 2009, the ECOFIN Council agreed that, in order to safeguard banking sector stability, in specific cases measures to deal with impaired assets could complement government guarantees for bank debt and recapitalisations. Drawing, inter alia, on the input of the ECB (European Central Bank 2009), the Commission issued a Communication on the Treatment of Impaired Assets in the Community Banking Sector (European Commission 2009a). While leaving the exact nature of an impaired asset scheme up to each Member State, the Communication lays down conditions in order to ensure a level playing field in Europe.

1 For a full overview of the measures taken, please consult ECB (2010b).

These policy coordination measures have not been confined to the banking sector. The Commission also stepped in to sustain the real economy by adjusting its framework for State aid to support access to finance. Under this framework, State aid rules are applied *"in a way that achieves maximum flexibility for tackling the crisis while maintaining a level playing field and avoiding undue restrictions of competition"* (European Commission 2009b). In December 2008, moreover, the European Council agreed an EU-wide economic stimulus of around €200 billion. The so-called "European Economic Recovery Plan" (European Commission 2008e)

was made up of budgetary expansion by the Member States worth €170 billion and EU funding in support of immediate action worth €30 billion.

However, some scepticism persists among observers as regards whether this was a genuine *EU* response or whether it was not simply a case of the EU coordinating national responses (Glöckler 2009). For example, in respect of fiscal policy the principles and guidelines of the European Economic Recovery Plan were rather vague, leaving the magnitude and timing of fiscal impulses mainly at the discretion of national governments (Quaglia, Eastwood and Holmes 2009: 83). In the field of competition policy, the European Commission could not prevent the rescue packages, e.g. for banks and the auto industry, from being organised largely along national lines. In institutional terms as well, as former Commission President Jacques Delors critically argues, *"when the crisis actually began, it seemed (...) to prove the intergovernmental method over the EU method (...) the fact that the initiative came from governments and not from the EU institutions will weigh heavily in the future"* (Delors 2010: 17). Indeed, the measures contained in the Paris Declaration (see Box 2) were very much driven by national governments. Some observers point out that the Commission did not play a central role in this initiative, but provided support via its existing infrastructure for cooperation between governments. In that sense, the fact that an EU umbrella could be opened at the urging of the Commission as cover for the agreed set of measures had more to do with the coincidence of the EU Presidency being in the hands of an activist French government, rather than a genuine capacity for action on the part of supranational governance structures (Glöckler 2009).

What do these examples of collective action show? Rational choice theory would have predicted, under the severe circumstances in which the Member States found themselves, a myopic, protective, "national-interest-first" policy response, with little regard for the negative spillovers into the other EU and euro area countries. However, there has been no meltdown of EMU. The EU/EMU framework has reacted in a pragmatic and flexible manner to the extraordinary conditions with which it was faced. One of the main reasons why the crisis has not deteriorated into a 1930s-style spiral of "beggar-thy-neighbour" policies was the existence of supranational institutions able to shape the Member States' behaviour. The Member States agreed to comply with some common minimum rules when trying to mitigate the effects of the crisis. Through the issuing of common guidelines, the EU institutions thus did play a significant role in remedying the "collective action dilemma".

Notwithstanding some caveats, it can still be argued that the EU's decision-making processes functioned quite smoothly during the financial crisis. In contrast, the episode of the sovereign debt crisis exemplified how an institutional framework based on decentralised policy-making, soft coordination and an insufficiently stringent enforcement of common rules displayed deficiencies in managing diverging national interests and perspectives so as to deliver a timely, resolute and, ultimately, market-calming policy response.

4.2 THE AD HOC RESPONSE OF EMU TO THE SOVEREIGN DEBT CRISIS

Whereas, in the early stages of the crisis, shocks came mainly from "outside" in the form of common disturbances to the financial sector that affected all the Member States, the focus of the crisis shifted in early 2010 to shocks coming from "within". At issue were the failings of governments themselves, the adverse implications of which were magnified by the markets. A coordinated response proved much harder to come by. Euro area member countries were expected by financial markets, unless they allowed their common currency to be exposed to unprecedented stresses, to act in a way that the EMU framework had not anticipated, i.e. to provide financial support to each other to ensure the financial and economic stability of the whole euro area. But even more

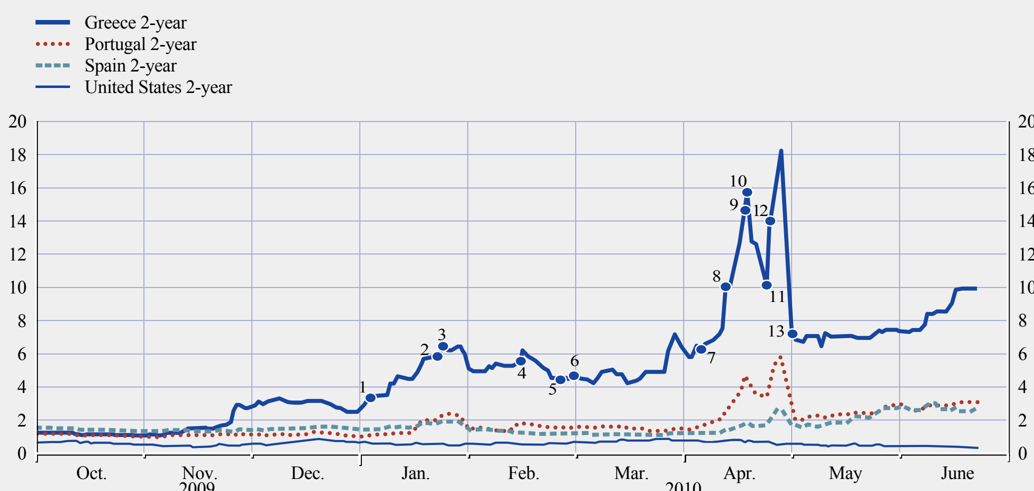
than that: the very foundation of monetary union expressly excluded that Member States assume each others' liabilities, via the "no bail-out" clause (Article 125 TFEU). This implied that the euro area had no contingency plan for providing financial assistance to one of its members (Greece). Instead, the euro area had to coordinate 16 different countries who shared no prior consensus on what balance should be struck between creating market impact, protecting taxpayers and limiting moral hazard.

In this context, the euro area's response resembled more of an ad hoc reaction than a structured process. Due to the shortcomings of the EMU framework, domestic political interests came to the forefront and figured prominently in official communications, impacting negatively on the financial markets. This translated into negative feedback loops between markets and policy actions. Markets looked to euro area governments to provide a unified direction, and reacted violently when political processes failed to deliver or resulted in disorderly communication from European policy-makers. Indeed, empirical evidence shows a correlation between daily spreads for 10-year government debt and significant political events (Carmassi and Micossi 2010). Chart 7 suggests that inconsistent statements from politicians at critical junctures may have deepened the crisis by instilling further doubt in the markets about the ability of the euro area to coordinate itself.

This reflects the fact that national governments and financial markets find it difficult to understand each other. *"On the one hand, markets*

Chart 7 Problematic interaction between politics and markets

(October 2009 – June 2010; yield in percentages)



1 14 Jan. 2010 Greece claims it will cut budget gap to 2.8% of GDP in 2012 from 12.7% in 2010
2 2 Feb. 2010 Prime Minister Papandreou says the government will extend public sector wage freezes
3 3 Feb. 2010 EU Commission says it will back Greece's budget gap reduction
4 24 Feb. 2010 One-day general strike against Greece's austerity measures
5 5 Mar. 2010 New package of public sector pay cuts and tax increases
6 11 Mar. 2010 Public sector workers strike
7 15 Apr. 2010 Euro zone finance ministers approve €30 billion emergency aid mechanism
8 22 Apr. 2010 Moody's downgrades Greece sovereign rating to junk
9 27 Apr. 2010 S&P downgrades Greece sovereign rating to junk
10 28 Apr. 2010 Ban on short-selling Greek shares in Athens
11 2 May 2010 Greece receives €110 billion aid package over three years
12 4 May 2010 Public sector workers stage nationwide strikes
13 9 May 2010 Overnight session results in €900 billion aid package from EU, ECB, and IMF

Sources : Bloomberg and Morgan Stanley Quarterly Short-Term Credit Market Update, 4th Quarter 2010

do not understand why the governments of European countries are slow to adopt the necessary measures to solve problems, postponing decisions and creating uncertainty about their actual intentions. On the other hand, the political authorities often do not understand how the financial markets work; they deeply despise them but at the same time depend on them to finance their budgets" (Bini Smaghi 2011).

Even the €110 billion package of bilateral loans to Greece of 2 May [12] under the specially created Greek Loan Facility failed to establish market confidence and was paradoxically followed by increased market volatility and soaring bond spreads. One answer could be that the ad hoc nature of the euro area's crisis response led markets to continuously doubt its credibility, creating a self-fulfilling downward spiral. Concerns about domestic fiscal conditions and debt sustainability even began to spread to larger euro area countries. Not until the far reaching policy decisions of the weekend of 7-9 May 2010 were euro area governments able to break this loop and get ahead of the curve. On this decisive weekend, the EU finally responded by creating two new crisis management instruments: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) (see Box 3 and Chart 8). These two mechanisms did not breach the aforementioned "no bail-out" clause because the Member States thereby did not assume liabilities but instead provided loans under strict conditionality.

The euro area policy response to the sovereign debt crisis thus provides further evidence of the types of institutional change observed since 1999, namely layering. In fact, the creation of the EFSM and EFSF amounts to the introduction of new layers, added on top of the existing structure and relying on already functioning infrastructures (EWG as Board of Directors of the EFSF, EIB to handle treasury services). This demonstrates that, even when subject to a severe crisis, EMU continues to evolve in an incremental way rather than creating a radically different arrangement from scratch.

12 In May 2010, euro area governments and the IMF decided, under stringent conditionality, to grant Greece a €110 billion loan, consisting of €80 billion of bilateral loans from euro area countries and an IMF contribution of €30 billion.

Box 3

GOVERNMENT MEASURES TO SAFEGUARD FINANCIAL STABILITY IN THE EURO AREA

From early 2010 fiscal imbalances in certain euro area countries began to be reflected in increasing tensions in sovereign debt markets. Euro area countries responded by affirming their willingness to take resolute and coordinated action, if necessary, to safeguard financial stability in the euro area as a whole. They also affirmed their commitment to conduct sound national policies in line with the agreed rules. The country experiencing the strongest market pressures, Greece, adopted additional measures to effectively reduce its budgetary deficit, for which it received support from the Heads of State or Government of the European Union on 11 February 2010 and of the euro area on 25 March 2010.

These measures proved unable to stem the rise in Greek sovereign debt yields, creating a risk of negative spillover effects that would endanger the wider stability of the euro area. In this context, on 2 May 2010 euro area countries agreed to activate, together with the IMF, a three year financial support programme for Greece. The financial package made available was

worth €110 billion. This consisted of €80 billion of bilateral loans from euro area member countries, centrally pooled by the European Commission, and an IMF Stand-by Arrangement of up to €30 billion. Disbursement of funds was made conditional on the Greek authorities implementing the ambitious programme of fiscal adjustment and structural reforms negotiated by the European Commission, in liaison with the ECB, and the IMF. All three institutions were tasked with monitoring compliance with the programme.

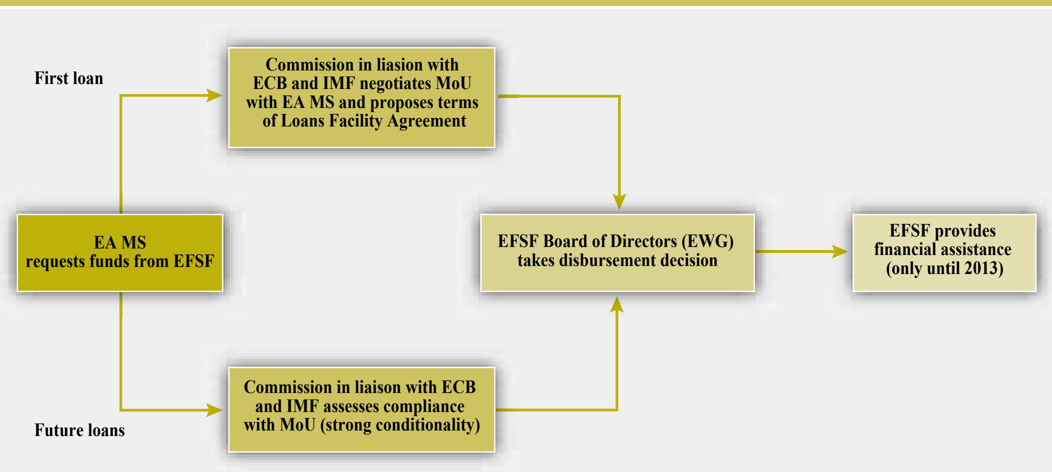
On 6-7 May 2010, tensions escalated abruptly in the financial markets. In line with their earlier commitment, European governments took urgent and unprecedented action to safeguard financial stability in the euro area. On 9 May 2010, the Member States agreed to establish a comprehensive package of measures, consisting of three elements:

Firstly, in line with the overall pledge to accelerate fiscal consolidation where warranted, the countries experiencing the strongest market pressures, Spain and Portugal, committed to implement significant additional fiscal consolidation in 2010 and 2011 and take structural reform measures aimed at enhancing growth performance. Spain and Portugal announced these additional measures on, respectively, 12 and 13 May 2010.

Secondly, the ECOFIN Council adopted a Regulation (No 407/2010) setting up the European Financial Stabilisation Mechanism (EFSM). The Regulation allows the Commission to raise up to €60 billion on behalf of the EU for lending to EU Member States experiencing or being threatened with severe economic or financial disturbances. EFSM financial assistance will be subject to strong policy conditionality and take place in the context of joint EU/IMF programmes, on terms and conditions similar to those of IMF lending. The extension of the Regulation has to be reviewed every six months.

Thirdly, euro area member countries, on an intergovernmental basis, established the European Financial Stability Facility (EFSF) as a limited liability company under Luxembourg law. Its purpose is to provide loans to cover the financing needs of euro area member countries in difficulty, subject to strong policy conditionality in the context of joint euro area/IMF programmes. These loans will be financed through the issuance of debt securities, guaranteed up to a total of €440 billion by euro area member countries on a pro rata basis. On 15 June, the EFSF agreement came into force and, by 4 August, member countries representing 90% of the shareholding had completed national procedures in respect of their guarantee obligations, thus triggering the activation of the EFSF. In its initial design, the EFSF was empowered to exclusively enter into loan facility agreements with euro area countries until 30 June 2013, no further instruments were foreseen at the time. The IMF is expected to provide financing amounting to at least half as much as the euro area contribution to each programme, on terms and conditions in line with recent European programmes.

Chart 8 How the EFSF works



Source: ECB.

5 TAKING STOCK AND LOOKING FORWARD

Looking at the first 12 years of EMU through the lens of the new institutionalism, what lessons can be drawn? How can we explain the rapidly changing assessments of EMU outlined in the introduction? And what is the likely impact of the crisis on the institutional development of EMU in the coming years? The subsequent Sections will address these two questions.

5.1 HAS EMU PASSED THE TEST?

Even though the new institutionalism takes a broad definition of "institutions" as covering formal institutions and rules as well as informal practices, a more refined differentiation between the institutions as such and the system of rules and procedures helps explain and identify the strengths and shortcomings of EMU's institutional structure. While institutions provided a flexible framework for interaction between the different parties involved, the implementation of the rule-based incentive system proved to be inadequate in view of the high level of economic interdependence within EMU.

On the one hand, the crisis has demonstrated the remarkable flexibility and resilience of the EMU framework. As outlined in Section 2, it has been able to evolve gradually in "normal times" through the processes of layering and redirection without requiring any Treaty amendments. Much of the Lisbon Treaty merely codified changes that had been introduced earlier on in practice. Most significantly, when they became massively stress-tested with the outbreak of the crisis, EMU institutions were able to react swiftly to extraordinary circumstances. This was made possible, inter alia, by an intensification of institutional relations within the existing structure.

Also noteworthy in times of crisis was the exemplary cooperation between EU co-legislators. This is amply illustrated by the extremely swift adoption of a revised regulation establishing a facility providing medium-term financial assistance for the Member States' balances of payments (EU Council 2009). This was aimed at raising the ceiling for the outstanding amount of loans to be granted to the Member States from €25 billion to €50 billion.[13] This revision was of critical importance given the severity of the crisis in certain non euro area member countries. In April-May 2009, the legislative procedure (which included the adoption of an opinion by the European Parliament and by the ECB) was completed within 40 days. While the EU machinery is often blamed for its slowness, this example demonstrated that the EU institutions are capable of reacting quickly and of cooperating with each other when conditions urgently require it.

However, this flexibility and resilience were not sufficient to address the fundamental mismatch between the level of policy interconnectedness and the level of institutional development prevailing within EMU. While euro area economies have become more and more closely interlinked, the institutional structure has proved to be insufficiently developed in the field of economic governance. For one thing, the EU, as a "community of law" resting on the principle of "mutual sincere cooperation" between its institutions (Art. 13.2 TEU), was fundamentally ill-equipped to countenance the possibility of an outright defiance of common rules, e.g. in the form of persistent fraudulent accounting and intentionally defective statistics that violated agreed standards. Moreover, the existing governance framework did not provide euro area member countries with the right incentives, be it sanctions or rewards, to internalise the constraints of monetary union. The fact that economic policy was predominantly a national responsibility militated in favour of "non-interference" in other countries' economic policy decisions.

13 This ceiling had already been raised from €12 billion to €25 billion in early December 2008.

This translated into insufficient peer pressure, reluctance to give early warnings or precise recommendations, and procedures – like the Excessive Deficit Procedure – which dragged on for many months. This was combined with a weakening of market discipline, as reflected in the low and converging levels of government bond yields over the first 12 years of the euro. As a result of these two factors, the Member States did not take sufficiently into account the externalities of their economic policies (i.e. the implications for the rest of the euro area). In line with rational choice theory, national governments were focused rather on domestic concerns. In fact, this phenomenon has been observable since the very creation of EMU. However, its concrete and dire consequences became apparent only with the outbreak of the sovereign debt crisis.

This helps to reconcile the sudden shifts in the assessment of EMU with its gradual institutional evolution (outlined in Sections 1 and 2 respectively). In its first decade of existence, EMU was largely praised, notwithstanding its weaknesses. Some – especially the ECB (2008a) – warned against the fiscal and macroeconomic imbalances, but policy-makers, economic agents, and, most relevantly, financial markets chose to ignore these. The institutional framework was thus largely considered as "fit for purpose". With the onset of the crisis, the risks that had existed since the early days of EMU abruptly materialised. Observers then suddenly focused on the shortcomings of EMU, some even going as far as predicting its meltdown should no reform be undertaken (Münchau 2010). One possible conclusion from these observations is that, similar to the financial markets, the assessment of EMU is characterised by a certain degree of procyclicality – successively downplaying and overemphasising its weaknesses, depending on the cycle.

The most topical question that arises from this stock-taking exercise is whether the crisis, which brought such important shortcomings to the fore, will spur the appropriate institutional reform.

5.2 IMPACT OF THE CRISIS ON EMU: WILL THE CRISIS BE "WASTED"?

It has been said that "a crisis is a terrible thing to waste".[14] In a similar vein, expressions such as "critical juncture" or "window of opportunity" flourished in 2010 in the public pronouncements of European policy-makers. Empirically, a number of discernible signs, both in the field of economic governance and of financial supervision, indicate that the crisis has provided a genuine reform impetus.

On the one hand, the so-called "Van Rompuy Task Force" was established in March 2010 by the European Council. It was chaired by the President of the European Council and composed of representatives of the Member States, the rotating Presidency and the ECB. Its official mandate was to *"present to the Council (...) the measures needed to reach the objective of an improved crisis resolution framework and better budgetary discipline, exploring* ***all options*** *[emphasis added] to reinforce the legal framework"* (European Council 2010a). It recognised the need to take a broad view of governance that encompasses fiscal policy, competitiveness and crisis management. It delivered its report on 21 October 2010, while the Commission (2010 b-g) presented its legislative proposals on 29 September 2010 (see an overview of the main innovations in Table 2).

Among the numerous proposals presented by the Member States and the EU institutions in the framework of the Van Rompuy Task Force, some would have been inconceivable in "normal times" as they touch the very core of national sovereignty. For example, Germany and France suggested in their joint proposal the suspension of voting rights for countries not complying with the Stability and Growth Pact (Lagarde and Schäuble 2010). Several Member States also proposed the creation of a Eurobond. These two proposals are quite far-reaching in terms of loss of national sovereignty. Before the crisis erupted, they could only be found in

14 Paul Romer, November 2004.

Table 2 Main innovations of the Commission's legislative proposals and the Van Rompuy Task Force report

	European Commission's legislative proposals	Van Rompuy Task Force report
Fiscal surveillance	- Notion of "prudent fiscal policy-making" - Operationalisation of debt criterion through the adoption of a numerical benchmark - Reverse voting mechanism for the imposition of sanctions - Graduated financial sanctions for euro area member countries (interest-bearing deposit, non interest-bearing deposit, fines) - Minimum requirements for national fiscal frameworks	- Reputational and political sanctions: enhanced reporting requirements, surveillance missions, public report to the European Council - Measures to strengthen Eurostat - Set of non-binding standards for national fiscal frameworks
Macroeconomic surveillance	- Scoreboard-based alert mechanism (set of indicators, alert thresholds) - Preventive surveillance based on discussions with the Member States and in-depth reviews - Excessive Imbalance Procedure (involving financial sanctions for euro area member countries)	

Source: Authors' own compilation.

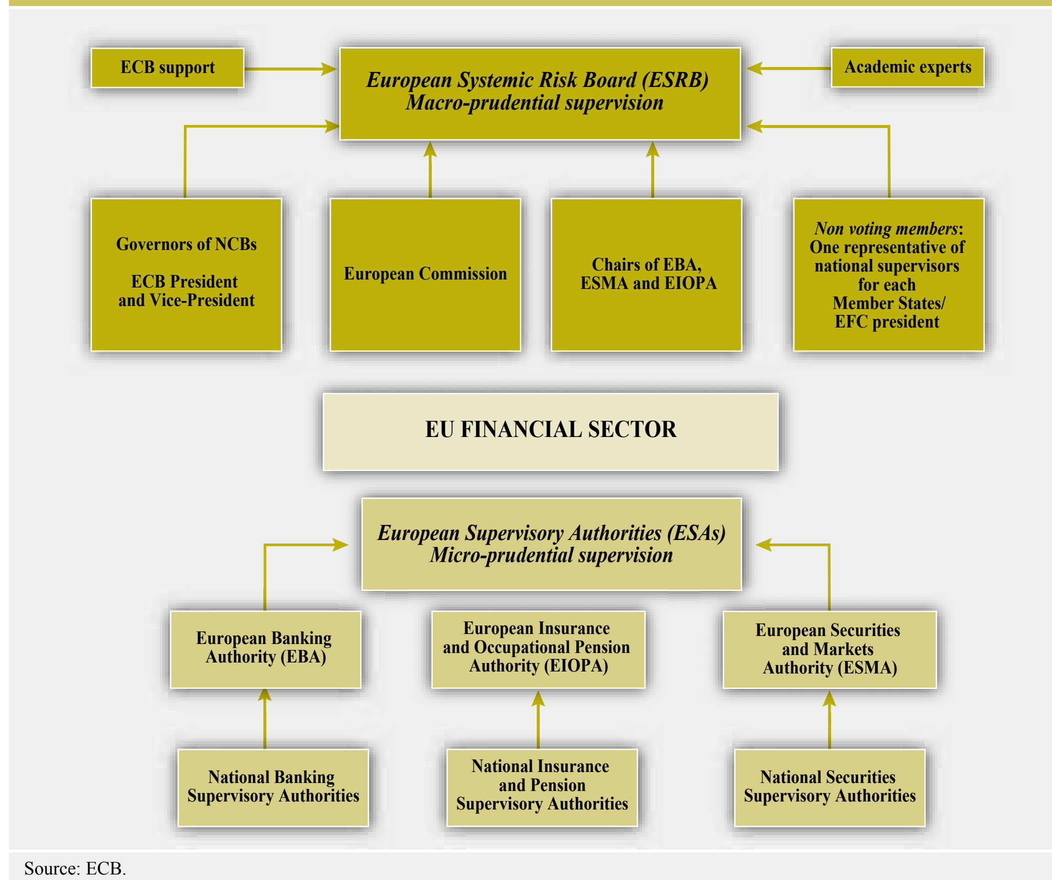
the academic realm, certainly not on the EU political agenda. The crisis has thus extended the boundaries of the public debate beyond what was politically conceivable under normal circumstances.

Another telling example of this impetus for change is the ongoing reform of the financial supervisory architecture. Even in the recent past any reform endeavour in this field had been strongly resisted by national authorities. By exposing important failures in the Lamfalussy structures, the crisis has clearly accelerated their overhaul and is bringing about a new financial supervisory architecture, i.e. the European System of Financial Supervision (see Chart 9 below). The package agreed upon by the EU co-legislators in autumn 2010 foresees the creation of three European Supervisory Authorities (ESAs) – each of them being in charge of overseeing a sector of the financial system (banking, insurance, securities and markets). The ESAs are responsible for developing technical standards with a view to a single EU rulebook and have the power to ensure the consistent application of EU rules across national jurisdictions. In addition, a new body was created in the form of the European Systemic Risk Board (ESRB). The ESRB is responsible for macro-prudential oversight of the European financial system as a whole – an area which was clearly missing before and during the crisis. It monitors and assesses systemic developments that could pose potential threats to financial stability and has the power to address warnings and recommendations to a national or European authority.

All of this seems to indicate that the crisis is accelerating institutional development. Does that mean that the EU and the euro area are on the brink of moving towards a radically new governance framework for their economies and financial sectors, as demanded by some observers (De Grauwe 2010)? In fact, many institutionalists divide the flow of historical events into periods of continuity punctuated by critical junctures, i.e. moments when substantial institutional change takes places thereby creating a "branching point" from which historical development moves onto a new path (Hall and Taylor, 1996: 942). Does the crisis represent such a "branching point" and is EMU moving onto a new path?

Probably not. In all likelihood, a fundamental overhaul of the existing EMU structure cannot be expected and the institutional changes to be anticipated will be of a rather gradual nature at best. As President Van Rompuy put it, "*there will be no sudden jump to a quasi-federal system with EU taxes, Eurobonds, etc.*

Chart 9 The new design of the financial supervisory architecture

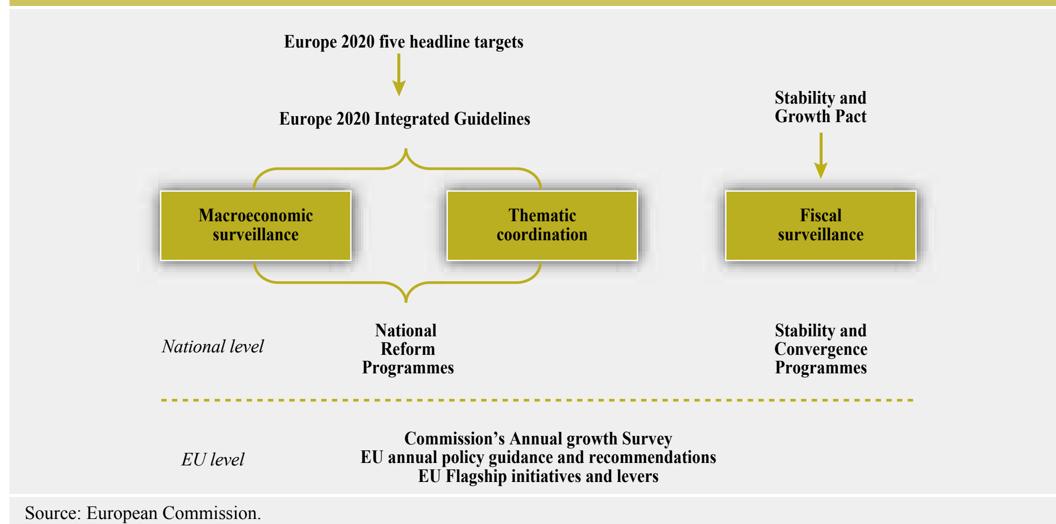


Source: ECB.

One may regret it, for reasons of constitutional logic or economic efficiency, but it is politically excluded in almost all (if not all) Member States" (Van Rompuy 2011a). This difficulty of shifting European institutional structures towards greater integration is due to the fact that the EMU framework did not involve any radical transfer of powers other than monetary policy to the European level (Bini Smaghi 2011). During the first decade of EMU, the institutional framework has thus evolved gradually, subject to a certain path dependence, and institutions have proved to be sticky. The evidence in crisis response and thereafter seems to confirm that institutionalism will continue to be a valid theory for exploring the dynamics of EMU over the coming years. In other words, the institutional framework will continue to evolve via the processes of layering and redirection.

As regards economic policy coordination and surveillance, the Europe 2020 strategy is a prime illustration of this trend: it mainly consists of streamlining and redirecting the Lisbon Strategy and its existing policy instruments. National Reform Programmes, which are assessed against the Integrated Guidelines for Economic and Employment Policies, continue to play a key role under Europe 2020 similar to their role in the Lisbon Strategy. The Integrated Guidelines, an instrument already prescribed in the Treaty, have been revised to reflect the new priorities of the Europe 2020 strategy. Their number has been reduced to 10 from the 24 under the Lisbon Strategy.

Chart 10 Governance of the Europe 2020 strategy



Source: European Commission.

More specifically as regards the debate on economic governance, it soon became clear that, in the short term at least, no new institution would be created, and no step change would occur as regards the repartition of competences between the EU and the Member States. As an example, the European Council conclusions of 16-17 December 2010 "*agreed on the text of a **limited** amendment to the Treaty on the establishment of a future permanent mechanism to safeguard the financial stability of the euro area as a whole*" (emphasis added) to be adopted by the simplified revision procedure (European Council 2010b). Using the typology of institutional change, one can argue that the reform of economic governance is most likely to be dominated by the ***redirection*** of existing instruments and the layering of an additional instrument. In fact, the six legislative proposals from the Commission do not envisage building a new governance framework from scratch, but rely more on the existing SGP. On the fiscal side, the Commission proposes to revise existing Council regulations initially adopted in 1997,[15] while the newly created framework for macroeconomic surveillance is clearly inspired by the SGP (e.g. preventive and corrective arm, Excessive Imbalance Procedure).

A closer look at financial supervisory reform also shows the incremental nature of the changes. The recently adopted legislation did not create the ESAs from scratch but upgraded the existing 3L3 committees by transforming them into authorities with legal personality and enhanced competences. As for the ESRB, it should be underlined that this new body has no legally binding powers and that it might be viewed as an umbrella organisation for existing institutions (mostly national central banks and national supervisors of EU27). This is once again an example of how the institutional architecture of EMU evolves via the process of ***layering***. The existence of a legislative review clause confirms that the financial supervisory architecture has not reached its final shape and will be subject to further incremental changes.

Institutionalism also provides interesting insights by arguing that gains from cooperation are the main determinant of institutional development (Hall and Taylor 1996: 945-946). Applying this assumption to financial supervisory reform

15 Council Regulation (EC) 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; Council Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive defi cit procedure.

makes it possible to understand why a "big bang" approach – such as the creation of a single supervisory authority – cannot be expected. The crisis has certainly revealed the costs of insufficiently harmonised financial regulation and supervision and thereby demonstrated the benefits of more integrated structures. As the Turner Review of the UK Financial Services Authority points out:

"*The current arrangements, combining branch passporting rights, home country supervision, and purely national deposit insurance, are not a sound basis for the future regulation and supervision of European cross-border retail banks (…) Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration"* (FSA 2009: 101).

There seems to be a general consensus among EU institutions about the gains stemming from the "more Europe" option. At the same time, these benefits are associated with losses of national competences. Following a rational choice logic, the Member States will agree to a deeper level of integration until the point where their marginal utility (i.e. gains from more integrated supervision) is outweighed by the marginal cost (i.e. loss of competences). This is amply illustrated by the compromise over financial supervisory reform, where the direct supervision of cross-border financial institutions by the ESAs[16] and the application of the so-called "safeguard clause"[17] were among the most contentious issues. In these two cases, a significant loss of competences on the part of national supervisory authorities and a limitation of national fiscal sovereignty were respectively at stake. As the Member States are still reluctant to transfer too many competences to the EU level, the financial supervisory architecture could not be subject to any "revolutionary" change. This amply illustrates the force of one "reproduction mechanism", namely the lack of interest in change shown by the dominating actors.

These empirical observations are fully in line with one of the main predictions of the new institutionalist literature, namely that policy-makers cannot go for a "breakdown and replacement" single-handed reform because this would not be sustainable and would eventually lead to a reaction bringing back old institutions (Guardiancich 2009). Institutional reforms therefore have an inbuilt bias towards incremental change, as the more sustainable and efficient form, rather than "clean slate" approaches. Even the most severe financial and economic crisis since the end of the Second World War is likely to verify this prediction.

16 The European Parliament was in favour of a supervisory arrangement according to which the European Supervisory Authority would "take over the supervision of financial institutions meeting the systemic risk criteria to the extent they could jeopardise the stability of the Union financial system, where a national authority has failed to exercise its powers" (European Parliament 2010, p. 12). The EU Council thus far has opposed any such direct supervision.

17 The Commission's proposal states under Article 23 that "the Authority shall ensure that no decision adopted under Articles 10 and 11 [in case of an emergency situation or of a disagreement between national authorities] impinges in any way on the fiscal responsibilities of the Member States" (European Commission 2009c). The exact scope and modalities of application of this safeguard clause are subject to tough negotiations between the European Parliament and the Council.

6 CONCLUSION

To sum up, the crisis will accelerate institutional development, but will do so only gradually. Even when subjected to a massive stress-test, EMU seems to have followed the same logic of institutional change as in its first eight years. Despite the very different external economic conditions, this paper has identified at least one common feature between the two periods examined: no matter whether in "fair-weather" or "stormy" times, EMU evolves through gradual on-path changes. However, this does not mean that the crisis will be "wasted".

First of all, the institutional evolution of EMU analysed throughout this paper must be put into historical perspective. In view of the high-stakes experiment it represents, EMU is a fledgling endeavour and – by any historical standards – has been evolving fairly swiftly. In the US, for example, the need for a common central bank only resulted in action with the Federal Reserve Act of 1913. Therefore, the importance of the changes observed since the creation of EMU, and in particular during the financial crisis, must be assessed against the historical scale commensurate with such endeavours: in Braudel's categorisation, the judgement should focus on the *longue durée, i.e.* the slow and subtle effects of deep social and economic changes, or the *époque, i.e. the* period of time over which medium-term trends can be meaningfully assessed (Braudel, 1949). Moreover, the cumulative impact of these incremental changes should not be underestimated. As President Van Rompuy has said, *"all these reforms comprise several elements, each one of which is small, but which together amount to a significant change in how we Europeans will jointly manage our integrated economy, in particular in the euro area"* (Van Rompuy 2011b).

Secondly, the fact that EMU will broadly remain on the same path decided in Maastricht is not negative as such. The decisive issue in order to bring EMU back to sustainable growth and fiscal discipline is to address the main shortcoming of the EMU framework so far, i.e. the internalisation of the EMU dimension into the Member States' rational choices. This can be achieved while remaining on the same path and without going for a "big bang" approach. For example, the new supervisory framework will be successful if it succeeds in compelling its various components (especially the national supervisory authorities) to internalise the European dimension when exercising their prerogatives.

Similarly, in the field of economic governance, and in order to ensure real commitment from policy-makers to *"regard their economic policies as a matter of common concern"* (Article 121 TFEU), the institutional framework must be enhanced in order to provide the right incentives and ensure compliance. The design of the permanent crisis management framework (i.e. the ESM) should also contribute to better shape the incentives of euro area Member States. Non-compliance with conditionality will be met with sanctions, escalating to de facto loss of fiscal autonomy. This should ensure that the recourse to the ESM will be sufficiently unattractive and should limit moral hazard. Financing the mechanism should also sharpen the incentives for all euro area countries to exercise effective peer pressure and surveillance to prevent crises. This should shape the expectations of fiscally undisciplined governments about how the other Member States are likely to behave in case of unsound fiscal policies and thereby sway their own strategic calculations.

Such an approach would contribute to matching the level of institutional development with the level of policy interconnectedness. The governance framework would better reflect the intensity of economic and financial interdependence within the EU and, in political terms, the reality of the euro area *"Schicksalgemeinschaft"* (Trichet 2010).

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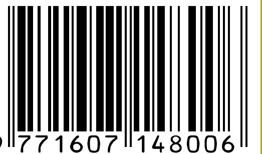
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