

1 Unity and Flexibility in the future of the European Union: the challenge of enhanced cooperation

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Economic Governance in Europe: between Unity and Flexibility

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1. Introduction

The European Union has been a story of cooperation and success. Through the previous decades, increased cooperation, the creation of the common market, and finally the European Economic and Currency Union have led to unprecedented levels of economic wealth, political stability, and peace among European nations. This success was possible due to deepened integration of an expanding Union. The process of European integration, however, is a transfer of national competencies to common (deliberative) bodies, like the Council, Commission, and Parliament. This transfer entails the fact that governments remain the principals of European integration, including the possibility of disintegration and fragility if governments do not react properly to common challenges.

On its 10th anniversary, the European Economic and Currency Union, the first endeavour of its kind in history, has slid into turmoil, recession, and crisis. A sharp downturn in financial stability, production, and trade, accompanied by growing unemployment, bodes of unforeseeable consequences for the European Union's cohesion and its institutions. This downturn is interdependent with different productivity levels and policy capabilities of the member states, their exposure to the crisis, and the impacts of the crisis throughout Europe. Extenuating existing differences in productivity and competitiveness, the possibilities of diverging policy responses, especially protectionism, undermine and erode the common European fabric and basis of stability, especially in an enlarged EU.

In order to provide shelter against the crisis and provide measures for structural stabilization, coordinated fiscal stimulation in the short term and improved regulation in the long term appear imperative, implying deeper levels of cooperation than before. This paper finds that the option of employing the Instrument of Enhanced Cooperation, as well as other possibilities for deepened integration and enlargement, is a necessary consequence of the challenges Europe is faced with. Since the long-term consequences of failing European unity are graver for European decision-makers than consequences of a flexibility policy, especially centripetal designs of deepened integration are vital.

2. Governance and Challenges

2.1. The State of European Integration: Achievements and Fragility

In its preamble, the signatories to the Treaty of Rome declared that they are “determined to lay the foundations of an ever closer union among the peoples of Europe” (EEC). Though the actual reasons for such a daring commitment are various, some facts stay the same while others lead to different degrees of commitment. The process of European integration is a transfer of national competencies to common bodies,

like the Council and Commission. This transfer entails two major difficulties, as cooperation by transferring power is costly. (1) There is no guarantee that other nations will commit themselves via resources and compliance symmetrically.

The very simplistic nature of European integration, based on a negotiated framework, is that of overcoming such a prisoner's dilemma by materializing the benefits of sustainable cooperation. (2) Even if cooperation is instituted, the benefits of working together are distributed asymmetrically or realized only in the long-term. Governments might abstain from cooperation, not because of distrust, but because of a lack of positive incentive. Both difficulties extend to the way European integration has been promulgated.

Since 1957, the face of the European Community/Union has changed dramatically. A period of almost continuous widening and deepening, especially in the last 25 years, has affected the EU's institutional mechanisms. Today, the European Union's political structure is "highly decentralized and atomized, it is based on voluntary commitment of the member states and its citizens", and it relies on nation states to administer state power (Hix 2005). Especially after phases of enlargement, not all member states have been equally committed to integration processes, creating a wider but weaker Europe, with institutions unable to function under the weight of participant numbers. The future of economic governance in the EU will be and already has been shaped by its ability to cope with growing conflicts due to different national policy objectives, economic structures and potentials, financial constraints, and societal preferences (Ahrens, Hoen and Ohr 2005). From this point of view, fostering European integration is a matter of creating institutional capability for overcoming a prisoner's dilemma and/or opening windows of opportunity of future steps of the delegation of power.

The term "governance" seems to dominate modern political science in many areas (Heise 2005). In his presidential address, delivered at the one hundred twenty-first meeting of the American Economic Association, Avinash Dixit defines economic governance as follows (Dixit 2009: 5):

"By economic governance I mean the structure and functioning of the legal and social institutions that support economic activity and economic transactions by protecting property rights, enforcing contracts, and taking collective action to provide physical and organizational infrastructure."

This paper considers economic governance and how it can develop in an EU that is facing major challenges in all relevant economic fields, both structural and short-term (Andersen and Sitter 2006; Dempsey and Brennhold 2005; Eijffinger 2008). There are three kinds of challenges. (1) Structural ones like the real exchange-rate imbalances within the Euro-zone as a result of an incompletely liberalized common market. (2) The robustness of the EU against exogenous symmetrical shocks, especially against the financial crisis and the accompanying consequences for unemployment and financial markets. (3) Do these challenges lead to closer and united cooperation among all member states? Will groups of member states lose their patience with Europe's inflexible unity and create a myriad of smaller "clubs within the club"? Or would some countries even chose exit options like those granted by the Treaty of the European Constitution and leave the EU completely?

2.2. Challenges ahead

2.2.1. Different Economic Capabilities and Enlargement

Looking to the structural challenges, the Euro area is often discussed as the stable core of European integration, providing shelter against economic storms. However, since the economic recovery of 2003, regional business cycles have become asynchronous, differing in the amplitude of growth and inflationary stability (Dullien and Schwarzer 2005). On the one side, there have been countries like Germany, the Netherlands, and Belgium, with low inflation rates but also low economic growth. On the other side, there are countries like Spain and Ireland with high growth rates but also high inflation. Under a regime of common nominal interest rates set by the ECB, resulting real interest rates vary a great deal. For Germany, the real interest rate is estimated to be too high, smoothing and partially hampering investment with further deflationary consequences. In the cases of Spain and Ireland, real interest rates are too low, further igniting economic growth above the structural optimum set by productivity and capital.

Literature has focused on the viability of adjustment¹¹⁶ within the common market, relying on criteria of optimal currency areas, for which the perfect mobility of goods, services, labour, and capital is essential. However, if for instance the banking sector is domestically organized, weak growth creates credit defaults and in turn less credit creation, further deepening the differences between Euro area States. The same logic is applicable to the eastern European states, where nominal exchange rates are fixed to the Euro and central banks try to maintain a peg, deprecating their currency in real terms (Dullien and Schwarzer 2005).

The consequences are large structural current account deficits in eastern Europe. Structural deficits create, both within the Euro area and between the Euro area and Eastern Europe, liabilities of the booming debtor countries toward the surplus ones. This is not problematic as long as the debtor countries are able to repay their loans. However, in a situation of imperfect markets, “repayment” is a very slow process, as described above, creating social costs in terms of unemployment and low wages or inflation in the medium-term. The challenge for the EU in this respect is the institutional inflexibility of the Stability and Growth Pact (SGP), which does not allow for the extensive fiscal stabilization necessary to create synchronous business cycles. The other alternative, fiscal transfers between the high-growth and the low-growth countries, has been impossible up to date, due to the problem of incentives for the high-performing countries (Arvai e al. 2009; Dullien and Schwarzer 2005).

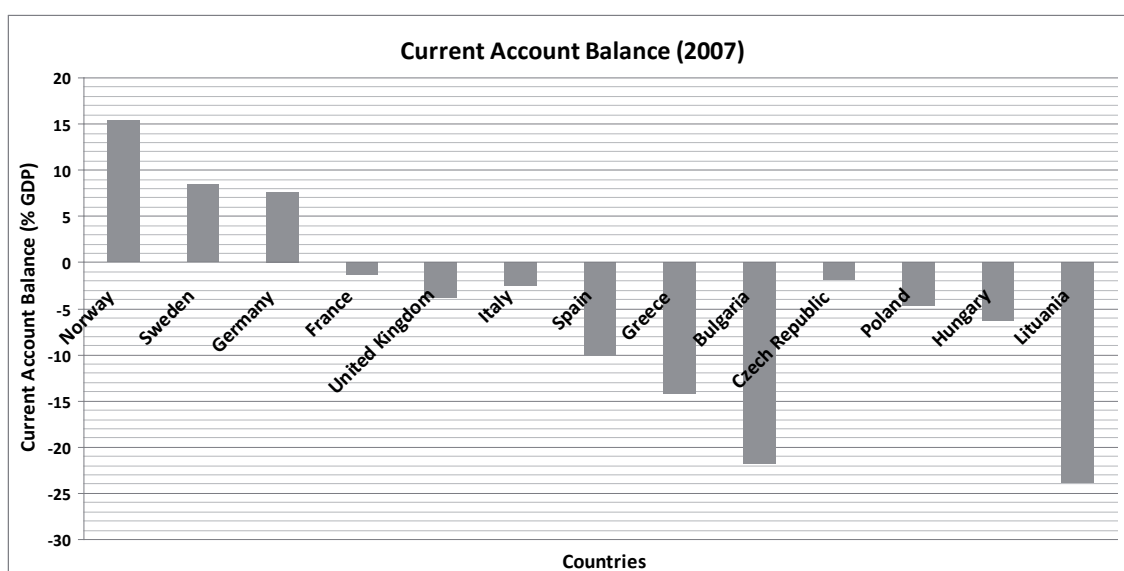


Fig. 1 Current Account Balance 2007, Source: IWD 2009

A special situation is the case of the emerging eastern European countries. The emerging countries of the southern and Eastern realms of the European Union tried to speed up their economic catch-up process. Being as domestic saving rates are too low to sustain double digit or comparably high growth rates, these countries were dependent on foreign investment flows to bridge the gap between needed investments and the domestic capital base. The subsequent capital inflows to finance the trade balance deficit are needed to stabilize the exchange rate. Maintaining the high structural current account deficits can be interpreted as continued demand for and use of foreign savings (Bolle and Pamp 2006).

However, especially because most eastern European economies are rather small compared to the capital inflows they received, systemic risks were entailed in terms of monetary and financial as well as macroeconomic stability. Entering the EU has helped to stabilize capital inflows and currency movements, both in real and nominal terms through currency pegging. In times of the crisis though, capital inflows are gravely endangered.

¹¹⁶ Given the mutually fixed nominal exchange rates, adjustment is only possible through increases or decreases of domestic competitiveness. For example, due to the deflationary pressure on wages and prices, German companies gain a better position in trade with the former overheating countries like Spain and Ireland, accruing to a net current account surplus. The same logic applies to Spanish exports, as prices are higher in relation to productivity than German goods creating current account deficits and according capital imports. According to the standard assumption of a perfect market goods are perfect mobile and real interest rates would converge.

Eastern Europeans' governments might be tempted and/or forced to devalue their currencies, further reducing the pace of domestic growth. As a result, these economies will run fiscal deficits far beyond the limits of trust in their fiscal reliability. If the wealthier states, possibly of the Union, do not come to the rescue of the new ones, a vicious downward spiral would encompass large parts of eastern Europe, with unforeseeable consequences for political stability.

2.2.2 Exogenous Shocks

The global economic crisis has subjected Europe to roughly the same symmetrical shock of tightening credit markets, falling stock markets, and collapsing demand (Boskin 2008). The effects of this shock have varied from country to country, however. The medium-term challenge has turned into a short-term one due to the impact of the financial crisis and the following inability of the former high growth countries to actually repay their deficits, creating almost catastrophic consequences for these countries. Though economic circumstances are comparable, the very existences of membership within the Euro area makes a difference in the implication for future economic governance European Commission (2009d).

Growth has slowed down all over the Euro-zone, and turned into recession for the major countries of the zone, third and fourth quarter 2008, as Figure 2 shows.

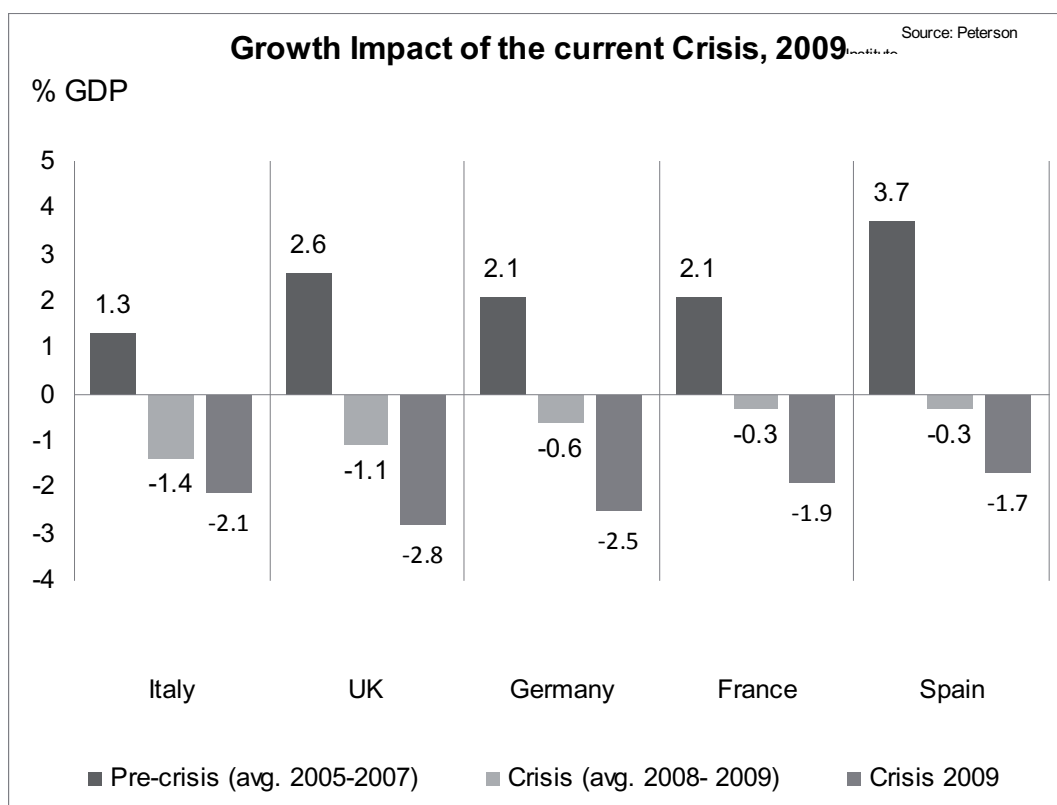


Fig. 2 Growth Impact of the current crisis, Source: Bergsten 2009

Actual downturn numbers tend to worsen for all of 2009, with IMF and OECD projecting a modest upswing in 2010. Though indications of an average output downturn of about 3-4% of GDP seem still manageable, the recession has asymmetrical consequences. Civil servants, medical professionals, and other basic services are at first relatively stable; the key impact of the downturn is made within the producing sector, accounting in some countries up to 40% of lost orders in industrial business like in Germany. Currently, European industrial production has dropped by an average of 18,4 % of previous levels last years.

Output growth differs among the major European states. Output mainly relies on aggregate demand. Germany is thus heavily hit, as large parts of the German economy rely on international trade, with a high share

of manufacturing. By the same token, consumption in Germany is structurally weak. Thirdly, the government is fiscally conservative, which does not ease the situation. The United Kingdom has been widely hit by the crisis, including falling housing prices and weakening foreign demand. On the other side, the government is able and willing to take counteractive steps, such as the currency depreciation of the Pound Sterling. France is in a middle position between both extremes. Demand is structural stronger than in Germany, and the government is more statist and keen to intervene.

Depending on the level, the very first consequence of such a steep sectorial downturn is rising unemployment. Prognosis by the Peterson Institute (Bergsten 2009) shows that especially Ireland, Spain, and the small Baltic countries will be heavily hit by soaring unemployment rates.

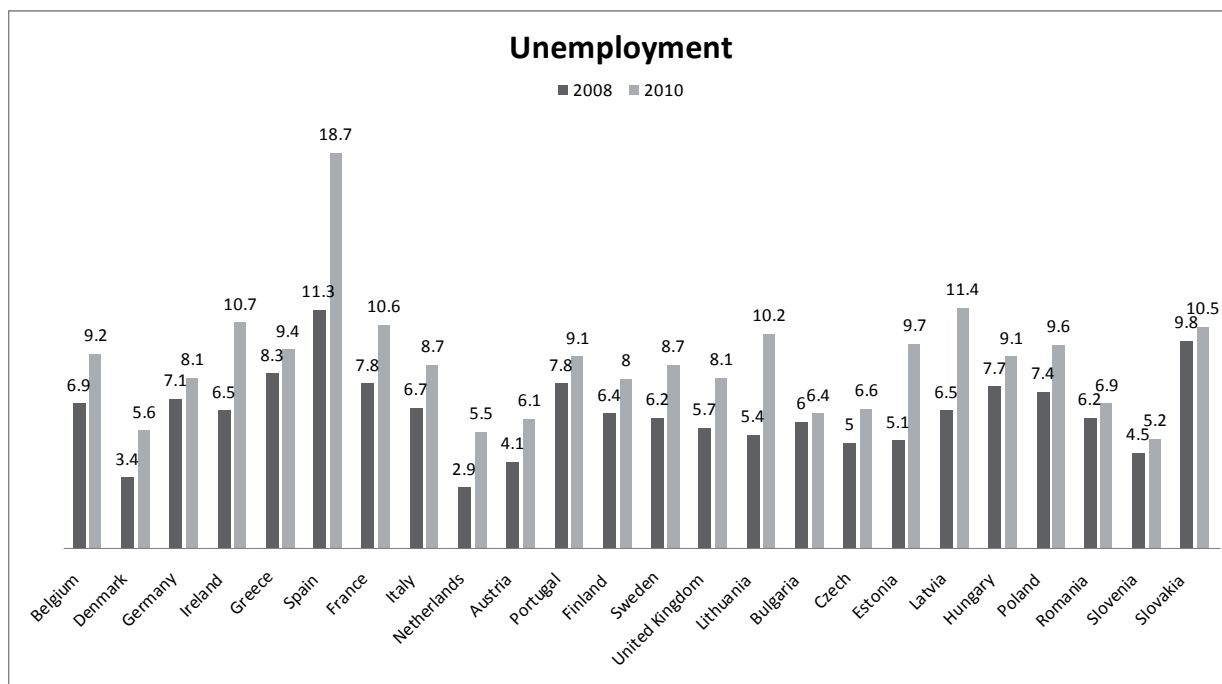


Fig 3. Unemployment Rate, Prognosis 2010, Source: Bergsten 2009

With unemployment on the rise, state fiscal balance is also under strain through increased social spending and the loss of tax and social security revenues. To stabilize social peace and to ensure re-election, governments tend to increase social spending, mixed up with productive investments in infrastructure and education (Boschat e al. 2008).

2.2.3. Fiscal Sustainability and Public Debt

The actual approach economic governance takes depends ultimately on the policy possibilities of the governments involved, i.e. preferences under the constraints of resources to commit to a policy. National policy interests diverge widely; policy preferences of governments are determined by structural and disposal factors. Under the structural ones, the general policy “philosophies” have to be considered, like different welfare state regimes. Disposal factors are acute demands from the electorate, and broader participatory moves of civil society actors. This is not an exclusionary distinction, as structural factors partially move due to disposal factors (Heise 2005).

Starting on the side of resources, the indebtedness of the nation as a whole, particularly of private and governmental actors, is a crucial factor. Most states were not prepared for the sharp economic downturn of the crisis. Well before the crisis, most European states commissioned more expenses for social welfare than sustainable in the long term. The long-term aging of Europe’s population calls the stability of public finances into question across the continent. These costs contribute to “hidden” net national debt levels and continue to

grow, being as the average age is raising in most countries of the European Union. Higher spending on health care and pensions will put enormous strain on budgets in several generations' time, meaning that today's spending must be balanced and the burden of debt reduced. These hidden levels are highest for the UK, followed by France and Germany, and lowest for Spain. Markets have recently begun to respond to these worrying trends in the current credit crisis, pricing government bonds higher in the countries with the shakiest public finances. The credit rating agency Standard & Poor's summed it up in another way, suggesting that French, German, and British debt could be rated at junk status in the following 10-15 years (Economist 23.3.2005).

In the short term, policy responses to challenges differ across Europe in terms of spending and creating national debt levels. Adding hidden and visible debt levels, sustainability gaps can be calculated, with Britain taking the lead by 570% debt as a percent of current GDP, followed by France and Germany with almost 350%. Only Spain is in better shape, with about 80% of sustainability debt. Taking into account the challenge of a short downturn, these countries have to adjust their revenues by dues and taxes. Here, especially Germany and Britain have to increase state revenues. Simply spending without raising the levels of taxes and repaying debt throughout Europe would be unsustainable, with extensive spillover effects. The free range of national policies would be infringed upon (IWD 2009).

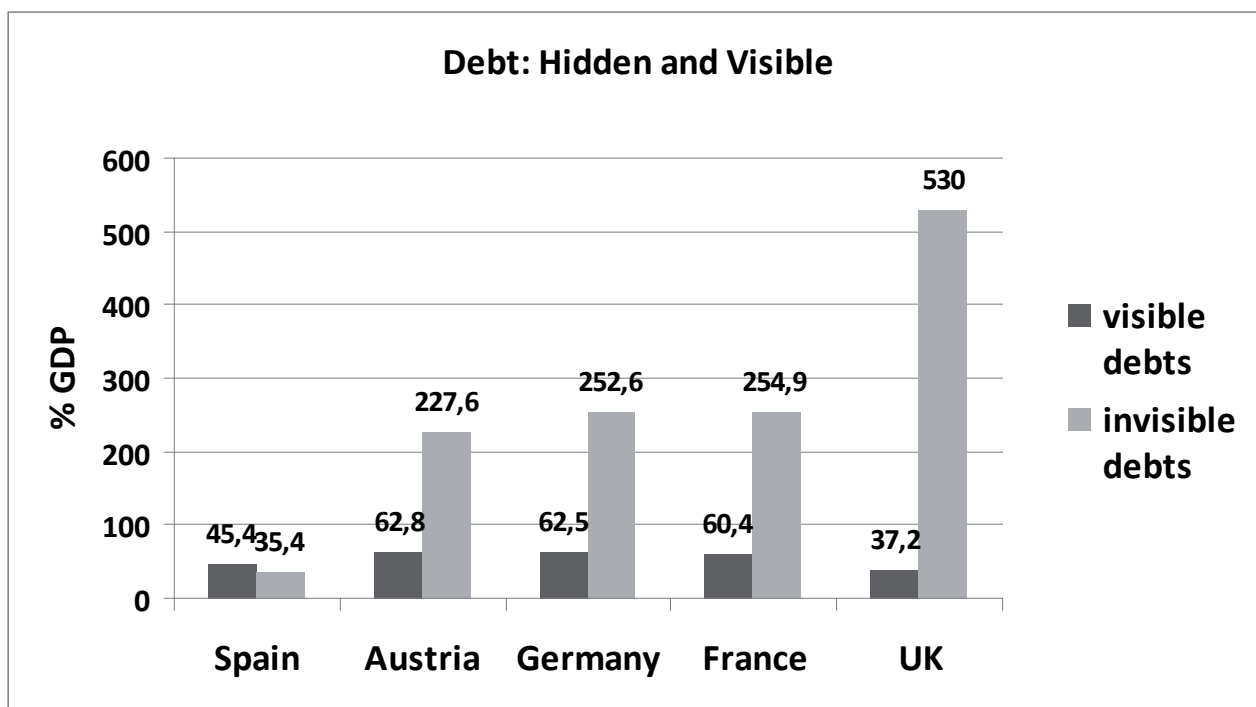


Fig. 4 Sustainability of debt (%GDP), Source IWD 2009

The systemic challenges the European Union is faced with indicate that a more coordinated European response would be desirable. However, recent studies imply that a reform process of the specific types of economic models is difficult to undertake on the national level; therefore, more pronounced integration policies are needed at the European level (Bosch et al 2007; Heise 2005). Approaches of governance might take a soft form, like the mechanisms of the Stability and Growth Pact, or be more pro-active through common spending mechanisms (Gros and Micossi 2008).

2.2.4. Protectionism

As pressure from the voter groups who believe that protectionism saves local jobs and helps struggling domestic industries rises, governments are often in a dilemma between introducing protectionist policies and cooperating intergovernmentally to contain the negative economic effects. In case of introducing protectionist

policies, governments can expect a gain in domestic support and short-time boosts to their economies, if other countries do not retaliate. But when other countries retaliate and introduce protectionist policies of their own, overall welfare declines and protectionism turns into a negative-sum game. Today, scholars draw parallels to the great depression of 1930 when they warn of the introduction of protectionist policies (Krugman 2009; WTO 2009).

The protectionism that Europe faces today is not based on tariffs like in the 1930s, but rather has a more creeping nature. Non-tariff protectionism in the EU is on the rise. The most present protectionist policies in the EU are the bail-outs of banks and the rescue packages for the automotive industries. While EU member states bail out domestic banks, they refused to bail out banks of other EU-member countries, creating a disadvantage for the concerned banks and their respective economies. Due to the fierce pressure from the wealthier member states, the European Commission softened its conditions for approving measures to rescue the financial sector which made way for massive capital injections to domestic banks (EUBusiness 2008). In the past, such financial boosts to banks were considered competition distorting. On the other hand, the heads of states declined the Hungarian proposal to provide the Eastern European banks with liquidity (Walker and Cohen 2009). Such policies threaten to create cleavages in the European Union and promote the formation of blocks of poorer and wealthier countries (Hartenstein 2009).

Another form of non-tariff protectionism currently pursued in Europe are subsidies to the various industries. While agricultural subsidies were a core component in the EU over the last decades, new forms of subsidies have emerged recently in the time of economic decline. The automotive industries received the lion's share of the subsidies issued in the last months. The global subsidies for automobile industries sum up to 48 billion USD so far (Gamberoni and Newfarmer 2009). Mature market economies account for 42,7 billion of this sum. Because automobile industries are a sensitive part of European economies, governments are willing to protect them. In a controversial move, the French President Nicolas Sarkozy proposed that the two major French car manufacturers shut down production facilities in the Czech Republic in order to maintain employment in France as part of its 6 billion Euro rescue package. As European governments and media raised major concerns against this proposal, the French government retreated, ensuring that the subsidies will be linked to conditions regarding the closure of foreign production facilities. Still, the demanded commitments – not to relocate the operating French plants – are raising concerns among European neighbours (Bouzou 2009). Correspondingly, the Italian Prime Minister Silvio Berlusconi announced a two billion Euro rescue package which also required keeping production facilities at home. Likewise, the Swedish government provided a 2,6 billion Euro package to help its major car manufacturer with the condition that a new model will be exclusively developed in Sweden. As a result, the car manufacturer stopped preparation for production in Belgium (Schultz 2009).

Such politicized lending undermines the efficient allocation of capital throughout the EU by protecting inefficient companies and reducing available funds for more competitive firms. Furthermore, these actions have disintegrative effects as Member States are tempted to look inwards than towards a pan-European solution to the decline.

3. Modes of Cooperation and the Capacity to Act

3.1. When Economic Flexibility becomes Crucial – Perspectives from Club Theory

For the given challenges, costs of non-action are far higher for Europe than costs of acting. If Europe cannot muster a common collective response, then the economic realities of the current crisis could lead to serious consequences for outreach and integrity of the Union. Russia, still wealthy from years of high energy prices, would be eager to regain influence in Eastern Europe and could conceivably use its petro-dollars to buy it, extending lines of credit at attractive rates to the former East Block countries as it has already considered doing with Iceland. Within the the core of Europe, the countries of the Euro area might pull the Common Market, their greatest accomplishment, apart by falling prey to protectionist sentiments (Economist 11.21.2008).

The general question of who provides economic governance does not necessarily lead to the answer “the government”. It is possible to organize governance in private hands, or in bi- or multilateral settings. In this paper, multilateral settings are discussed due to the very nature of external effects and common goods problems posed by the challenges for European countries. Here, mechanisms of deepened integration and differentiation are of special interest (Acemoglou e al 2008).

In order to understand the driving forces behind feasible forms of closer cooperation, one must explain the EU's complicated decision making process first. Who are the central actors and what are the major institutions? In the past few decades, scholars have discussed whether EU decision making processes are dominated by intergovernmental institutions like the European Council (Moravcsik 1997) or supranational agents like the European Commission and the ECJ (Stone Sweet and Sandholtz 1997). Moravcsik and others have argued that member states retain control in the EU polity and supranational actors merely exist because contracts between states are incomplete and commitment must be facilitated. Neo-functionalists, on the other hand, see rising numbers of cross-border transactions and transaction costs as drivers for societal demand for supranational rules. The relationship between these two theories is best described by issues of delegation, agency, and accountability.

Rational choice institutionalism (RCI) has developed into the main approach in research on executive politics of the EU (Tallberg 2007). RCI is characterized by three essential elements: *“methodological individualism, goal-seeking or utility maximization and the existence of various institutional or strategic constraints on individual choice”* (Pollack 2007: 3).

RCI and Principal-Agent analysis provide an appropriate framework for these issues. On the basis of Rational Choice Institutionalism, P-A theory deals with delegation of authority by “principals” to “agents” (Pollack 2007). This means that voters, the legislative, or the government can play the role of principals inside a given polity, delegating specific tasks to agents such as the executive, independent regulatory agencies, and courts. The P-A approach therefore combines both intergovernmentalist and neofunctionalist claims. Seminal works by Majone (1996, 2002) and Pollack (1997; 2007) apply theories to Europe's political system that were previously developed on the interaction of US Congress with non majoritarian regulation agencies (McCubbins e al. 1984). This more subtle attempt (Kassim and Menon 2003) to “transcend the intergovernmentalist-neofunctionalist debate” states that the autonomy of different actors within the complex EU political system varies over time and issue-area (Pollack 1997). Minimization of transaction costs, monitoring compliance, filling in incomplete contracts, and agents' expert and credible regulation are all included in this approach (Pollack 2007). Following Rational Choice Institutionalism in our analysis of European economic governance, we must therefore identify how the relevant actors are affected by recent economic challenges and what options they have for closer cooperation.

The original six member states began cooperating in three European Communities, the European Coal and Steel Community (ECSC), the European Economic Community (EEC), and Euratom. Today, supranationalization is strongest in the first pillar of the EU polity. However, this strong movement toward the community method within the EC pillar is set against a dominance of cooperation at a government-to-government level in the other two pillars, as well as being confronted with the fact that some member states do not participate in cooperation at all in some areas. The current heterogeneity of member states' interests has lead to a slowdown in the integration process (Schäfer 2007). Discussions about the Convention on the Future of Europe have demonstrated the difficulty in reforming the EU or even establishing new areas of common governance. The question is whether groups of member states will lose their patience with Europe's inflexible unity and create (even more) clubs within the club? The following diagram gives an overview over policy areas and EU involvement.

Community Method	Shared authority - EU and MS	Limited EU authority	No EU authority
Market regulation and internal market	Regional policies	Health	Human and civil Rights
Monetary Union (not all MS)	Competition policies	Education	Fight against domestic crime
Foreign Trade	Industrial Policies	Defence	Housing policy
Customs Union	Environmental Policies	Fighting cross-border crime	
Agriculture	Working Conditions	Social Policy	
Fishing	Consumer Protection		
	Transport Policy		
	Monetary Policy		
	Foreign Policy		

Tab. 1 European Club goods: Different level of EU involvement

Club theory provides a good approach of how to predict a possible multi-speed Europe. At present, EU member states participate in all common policies except the European Monetary Union and the Schengen agreement. However, a club is defined as a voluntary association of actors which jointly produce a common good and share the benefits of this excludable good. These characteristics lead to problems of optimal club size. “The costs of production of integration goods are not independent of the number and the degree of homogeneity or heterogeneity of EU members” (Ahrens, Hoen and Ohr, 2005). The probability of limitations of the number of countries participating in further integration steps has increased with the last enlargement rounds and growing heterogeneity.

3.2. The Instrument of enhanced Cooperation: Mechanism and Implications for Economic Governance

A broader use of differentiated integration mechanisms was initially discussed as a theoretical possibility after the first enlargement (Emmanouilidis 2007). The Treaty of Maastricht allowed for the first time the non-participation of some member states in policies that form part of the European Community, foremost in the areas of social policy, defence, and monetary union (EMU). This was called “pre-determined flexibility”. With the Treaty of Amsterdam (1997), the accommodation of “enabling flexibility”, which allows a sub-group of member states to integrate a number of policies in the first (EC) and the third (Justice and Home Affairs) pillars without involving all 15 member states, was incorporated. This “enhanced cooperation” had to be approved by a unanimous vote from the European Council, which allowed a veto-right for every single country. As it had not been used, the Treaty of Nice (2000) modified the provisions, extending the scope of this instrument to the second pillar, foreign policy matters (CFSP – Common Foreign and Security Policy), while facilitating the application for its exertion. Enhanced cooperation can occur between 8 countries if approved by qualified majority, except for areas that fall under exclusive EU competencies and for defence and military issues.

The overall aim of a final unified regulation for all EU members becomes apparent when regarding the criteria that have to be met to introduce enhanced cooperation via Articles 43-45 TEU (Ahrens and Zeddies 2006; Bordignon and Brusco 2003). Enhanced cooperation may not extend or revise existing EU legislation. It may not regulate areas of exclusive EU competency (e. g. monetary policy, trade policy). The instrument of enhanced cooperation can be introduced as a last resort when the Council, acting on a proposal of the Commission, has concluded with at least a qualified majority (in some areas unanimity is required) that unified action of all member states is not possible. A minimum number of eight willing member states is necessary to start the process. They have to ensure that other member states can join them. The instrument of closer cooperation is heavily guarded against attempts to create a “Europe á la carte”, which would restrain a multi-speed Europe more than allowing it. The only initiative to use Enhanced Cooperation known to the authors is an attempt to harmonize the divorce law on the EU level because of the diverging interests of EU member states and the lack of progress on the matter. Even here, a proposal has not yet been made to the Council to harmonize the divorce laws because the number of countries involved is not considered as large enough to meet the Council’s majority requirements.

In the case of economic governance, the high hurdles for closer cooperation have specific consequences, tending to dampen rather than encourage closer cooperation because of the redistributive effects that economic policy making implies. The problem is not to create a new “club of like-minded governments”, but to include those with different interest in the short-term, but common ones in the long-term. In this respect, the solution might be in the middle, allowing like-minded governments to form a new club, but under certain provisions. It maintains that enhanced cooperation of a few member states is efficient, or in political terms, leads to outcomes that tend to find acceptance in national electorates. The additional requirement of the club is to ensure learning and adaptation capability of the club, i.e. flexibility to encompass changes in preferences of its members, offering voice and exit options as well as offering openness towards new members. General openness towards new members, the ability to exit, and the right to have “voice” for all members of the new club should be basic principles. In such an environment, deepened integration by a part of European member states yields success in the future (Ahrens, Ohr and Zeddies 2006).

One has to consider however, that enhanced cooperation, following the idea of a “Europe á la carte”, will produce resistance from EU institutions as well as, most likely, from all member states which are not involved in the short-term. Hence, closer cooperation at least on the basis of existing EU institutions seems inevitable, with

the ability to include as many members as possible (Emmanouilidis 2007). Analysis of deepened integration in the broader sense is therefore recommended, including given European frameworks of economic governance on a case by case basis, being as they exist now and could be developed in the future, including answers to the challenges ahead (Hungdah 2005). Viable institutional responses, especially enhanced cooperation and possible solutions using enhanced cooperation or deepened integration, are still untried for European Monetary and Economic Union and subfields of capital market regulation and labour market regulation, creating a kind of “experimental laboratory” (see Appendix). As medium-term structural adjustments to the Internal Market are insufficient to solve the current economic problems, economic governance within EMU, in terms of creating fiscal coordination, seems to be most suitable solution for the European Union’s economic challenges and the dangers for the Union’s integrity the possess.

4. Enhanced Cooperation: Proposals and the need for Revision of Coordination

4.1. Managing EMU

4.1.1. The SGP and Eurogroup: A strong Case for Enhanced Cooperation

To guarantee cohesion within the EMU, certain basic principles of economic policy should be kept and developed on the European level (Becker 2008b). Among these are the soundness of monetary policy, the independence of the ECB, budgetary discipline, and sustainability. Budgetary discipline is of special importance because the very effectiveness of the European mix of economic policies depends on sound fiscal stances. Over-reached and possibly unsustainable fiscal deficits create immense spillover effects onto interest rates and, secondly, higher inflationary pressures, which the ECB would have to face. The current Stability and Growth Pact remains the central coordination mechanism applied to provisions of sustainable debt management and fiscal restraint (Begg 2008).

Within the EMU, the credibility of the SGP has been troubled from its very introduction, however (Becker 2008a). The accession of Italy, Belgium, and Greece to the Euro area, despite their sizable national debts, immediately called the Pact into question. A more significant challenge arose in the early 2000’s, as the major Euro area economies Germany and France passed the 3% deficit hurdle for 3 years in a row. The deficit-spending duo ultimately responded, not with fiscal prudence, but with a loosening of the Pact in 2005. The exceptions for budget deficits were expanded, permitting them during the slightest of recessions or even periods of slow growth, as well as for spending on education, research, foreign aid, and anything contributing to the „unification of Europe“ (Economist 23.3.2005). At the same time, the international monitoring process was strengthened with an „early warning system“ to help members avoid deviations from their medium-term budget goals. The ECB expressed serious concern regarding these developments and hinted at the necessity of raising interest rates if government profligacy led to inflationary pressure (Schwarzer 2009).

The calls for more flexibility in the SWP led to the reform of 2005. In the period of relatively good economic growth that followed, all Euro area members were able to push their budget deficits below the 3% hurdle, and some were able to pay down the balance of their debt. Now, in times of crisis, it remains to be seen how well the countries respond to the short-term difficulties with strategies that do not hinder their long-term economic growth (Begg 2008). In general, the need for individual nations to formulate flexible economic policies to address their individual needs is valid. Ultimately, though, all members of the Euro area are subject to the same long-term challenges of aging populations and the need to restrain free riding on the common currency. Especially to combat the free-rider problem, the Euro area needs effective and enforceable rules like the Stability and Growth Pact. The reform of the pact in 2005 did address these issues, focusing on sustainability and demographic challenges, but at the same time allowing expenses for structural reform measures supposedly fostering future growth. The major problem of the pact is that decisions are made in the ECOFIN council by the very same principals affected by contingent sanctions. This problem has not been solved. A further problem lies within the long-term capabilities of governments to repay their debts, an obligation which the Pact is not able to achieve (Becker 2008b). The Pact should be reformed again, following the current economic crisis, to require the consolidation of budgets in good times. The consolidation of budget has thus far been the weak link in economic policy within the Euro area, and this threatens the currency’s long-term stability.

Under the circumstances of the crisis, further coordination is a vital measure, not manageable by the SGP alone (Eijffinger 2008). The often-criticized leverage and broad room to maneuver in terms of expenditure in cases of exceptional circumstances seems to be a useful device now (Bergsten 2009; Boschata et al 2008). But even if the SGP offers increased discretion for national governments to spend money, enhanced cooperation comes to play on how to spend it and where to raise it. (1) Looking into the “how” to spend it, coordination is necessary. This is due to the fact that large spending programs create external effects over all of Europe, being as European economies are highly interlinked with each other (Arvai and Sitter 2006), creating free-riding problems and in turn lowering the net effect of public spending by absorption or beggar thy neighbor policies, respectively. There are other, technical aspects, pertaining to the question of fostering consumers by lowering taxes and/or giving consumption vouchers, or, on the other hand, spending on investments with quick net effects on the real economy. These technical aspects have political consequences, as attempts to increase consumption often lead to more savings in times of crisis, or to dubious schemes like the German “Abwrack-Prämie”, offering a credit of 2500 Euros toward the purchase of a new car in exchange for scrapping an old one, coincidentally coinciding with an election year. Common European spending policies could decrease the influence of political business cycles, channeling funds into sound public investments. Hence, both the level and the mode of spending need European coordination in order to shelter against the crisis. (2) Moreover, going into the “where” to raise it, coordination on a European level is also entailed by the high levels of debt states have, on account of the systemic risk of mutual debt default and the fiscal constraints and rules by SGP (Begg 2008).

The level and mode of additional fiscal expenditures by European governments are intrinsically connected with the political base of raising the expenses. Given the grave challenges of the crisis in contexts of structural divergence but with the need for coordination, the answers to three questions are vital: (1) how to design a mechanism that allows for fiscal discretion while ensuring budgetary sustainability? (2) how to avoid spillovers, external effects, and reap the benefits of coordinated fiscal stimuli? (3) How to account for different political and economic speeds, capacities, and approaches, creating European fiscal stimulation and long-term sustainability?

Governance options entail two solutions: strengthening genuine supranational institutions, the Commission and Council, or creating, deepening, and continuing intergovernmental mechanisms for policy coordination. The informal forum of the Eurogroup seems to be a natural candidate for the application of deepened integration (Begg 2008; Heise 2005). The institutional capacities for Euro area governance are currently strongly dispersed; competencies are divided between ECB, Commission, and ECOFIN, each body entails different views on the policy mix. The Eurogroup, comprised of the ministers of the national ECOFIN ministers responsible for financial affairs, has become the most important forum for coordination among Eurozone member states. Here, identity is divided between those governments who are affected by long-term budgetary sustainability and broad fiscal discretion in times of crisis on the one hand, and the common monetary policy on the other hand, respectively (Begg 2008). The activity of the Euro group is in so far mainly debate and discourse among members as well as management of the SGP. With reform to the SGP, however, there has been a creeping development of the group towards becoming the central (informal) body deciding over breaches of the Pact (Heinen 2008).

In the realm of enhanced cooperation, the Lisbon treaty adds a new chapter 3a, including options for enhanced governance among Euro zone members. The Eurogroup is also institutionalized for the first time, analogous to Art. 99 of the Maastricht treaty. Furthermore, the Eurogroup gains exclusive decision making powers, for example nominating ECB Executive Board members and joint representation in international financial bodies. As described before, the instrument of enhanced cooperation has been precluded from deepening competencies for the Eurogroup because all member states were able to find compromises regarding the special rights for Eurozone members. It is nonetheless noticeable that the provisions of Lisbon do not include explicit decision-making powers of the Eurogroup concerning the economic governance of the Eurozone.

Further development of the Eurogroup within the realm of enhanced coordination would entail both widening of competencies of Eurogroup members and allocation of decision-making about new and old competencies regarding the Eurozone on the level of the group. It is clear that some of the Eurozone member states, especially Italy, Spain, Ireland, and Greece would favor common Eurozone decision-making rule for further fiscal coordination and even possibly joint issuance of public debt, i.e. „European bonds“. These bonds would be backed by all of the EU’s economies, thus allowing weaker member states to borrow at lower rates than they can currently find on the market. It is therefore questionable if such ideas would find a qualified

majority among EU members and, by the same token, within the Eurogroup for setting up a process of deepened integration. This is because the difference in budget deficits and trade balances has sparked an unprecedented widening of spreads in Eurozone national bonds since the start of the credit crisis in 2008: Greece currently pays nearly 3% more for new bonds than Germany (Schwarzer 2009). The German finance minister, Peer Steinbrück, has suggested instead the “normal policy mix” of reducing budget deficits and improving competitiveness to cure the East’s ills (Economist 2.26.2009). The realization is growing, though, that conventional long-term economic policies might not be enough to prevent an economic melt-down in the short term (Rodrik 2009).

These trends are threatening the stability of the Eurozone and require a coordinated policy response from the member states including those who are unwilling now, like Germany. As a compromise between full-fledged fiscal coordination and mere budgetary restraint and loose informality, one possibility would be the empowerment of the Eurogroup with sanctioning mechanisms to enforce the execution of the Integrated Guidelines for Growth and Jobs. Another possibility would be the expansion of the powers of the Council to include provisions for mandatory guidelines in the fields of fiscal, employment, and economic policy. In any case, a majority of the Euro members in favor of such a solution is not readily apparent, not just because of the different consequences of the crisis. France, along with Spain and Italy, is a natural proponent of such a scheme, allowing it to regain some of the statist influence that it was forced to give up following the introduction of the Single Market and the Euro. The smaller Euro states are likely to oppose such a plan, fearing the influence of the larger states in their internal affairs. These opponents would have an ally in Germany, who sees the state’s role in *Ordnungspolitik*, or non-interventive regulatory policy, and not in statist governance. Should the Euro area members find an acceptable compromise, however, the instrument of enhanced cooperation or other, future forms of governance could be used to legally bind them to specific goals. The acceptance of these goals would then become part of the Amsterdam criteria for accession to the Eurozone.

4.1.2. Enlargement and Promotion of Economic Stability

As a result of several rounds of enlargement, the European Union has grown beyond the core group of large, established industrialized countries and now contains many member states of various sizes and in various phases of economic development. In particular, the former East Block states stand out because of their large catch-up potential. In order to fulfill this potential and realize high growth rates, these eastern European economies require either high savings rates or large influxes of foreign capital. As a group, they have generally chosen the latter path, running current account deficits to support capital investment and domestic consumption at the same time (Bolle and Pamp 2006). In the years before the financial crisis, this model worked well. Currency pegs caused exchange rate risk to appear to vanish, economic growth boomed, and higher standards of living via increased consumption assured domestic and political stability.

The credit crisis has dramatically altered this situation and poses a significant challenge for the eastern European states and the stability of the EU as a whole. The crisis has upset the capital flows to the East and caused the system of exchange rate pegs to falter. In the case of Latvia, the IMF has to support the country’s currency with a 7.5 billion loan. Should any country have to abandon its peg and devalue its currency, the lower exchange rate would badly hurt the economy by forcing debtors to repay their foreign loans in much higher terms denominated in the local currency. Furthermore, devaluation could easily frighten investors and lead to full-scale capital flight, plunging Eastern Europe into a crisis similar to the Asian fiasco of 1997.

One obvious solution to this risk would be membership in the Euro zone, which protects its members from exchange rate risk. With the exception of Slovenia, the eastern European countries have put off the reforms needed to gain entry to the common currency, however (Bolle and Pamp 2006). Furthermore, membership in the Euro zone demands great fiscal discipline or effectively centralized wage negotiations to maintain economic competitiveness, for the freedom of monetary policy is relinquished to the ECB and SGP. Since both fiscal and wage restraint are unpopular, the Eastern European countries are unlikely to join the Euro in the near-term.

Instead of Euro membership, another solution is needed to stabilize the currency flows and current accounts of Eastern Europe. The long-term success of the eastward enlargement depends on the eastern European countries being able to build their capital stocks, sustain high growth rates, and gradually approach the standards of living enjoyed by their EU counterparts. To this end, the EU must seek to stabilize their currencies in the short-term.

Capital flight is a very real risk that could cause devastating harm to the eastern European economies and in turn, lead to mutual defaults in many Eurozone countries and destabilization of various member states. In the medium-term, the EU should encourage higher savings rates and an expansion of the export base to close the current account deficits. In the long-term, the former Eastern block must start down the path to Euro membership by fulfilling the Maastricht criteria. Only by joining the Euro can the eastern European states be safe from exchange rate risk and capital flight that threatens their continued economic prosperity.

Being as these states remain hesitant about joining the Euro, enhanced cooperation between those member states in the East and West highly affected by mutual default could form a club for providing emergency funds. Countries such as Latvia and Hungary, whose economies had borrowed heavily in Euro loans, have required bail-outs coordinated by the IMF and European Commission to prevent their currency from collapsing and to avoid massive defaults on their Euro debts. The other countries of Eastern Europe, although in less dire straights, are facing similar problems. This has led to calls for the EU to organize a bailout of its new members to help their still fragile economies weather the financial storm. In particular, Austria, Greece, Italy, Finland, Sweden, and Belgium are interested in such a deal, since many big banks in those countries made the loans in the East that are currently looking very wobbly. France, too, has expressed interest in such a scheme as part of a general strategy of strengthening economic governance in Europe.

Germany has clearly opposed any such notions, though, rejecting plans for a 180 billion rescue fund for east and central Europe at an EU summit on March 1, 2009. The German Chancellor's government fears that Germany, as the biggest contributor to the EU, would have to pay for most of the rescue, and is loath to abandon her goal of a balanced budget by 2011 in this election year. Other European leaders, especially those from the relatively healthy economies of Poland and the Czech Republic, also found consensus in opposing the plan, based on the consideration that talk of a 'rescue' sends a dangerous signal to credit markets, since not all of the former Soviet countries are facing such significant problems.

If it comes to governance, a full-blown Commission lending scheme, along the lines of an IMF bailout, could be set up and might even serve to advance European integration, since the conditions for the loans could be used to prepare the recipient countries for entry to the Euro zone. As such, a collective rescue scheme might find strong opposition by Germany, but also Poland and Czech Republic; the other, more affected countries could form a core of deepened cooperation regarding mutual bailouts. A bailout scheme would only be possible for the non-Euro countries, however, since the rules of the common currency preclude the rescue of any Euro member state. Credit market commentators have noted this discrepancy and openly called the viability of the non-bail-out provision into question, rightly pointing out that is unlikely that the economic core of the Union would help the periphery but turn their backs on one of their own. Here again, it is exemplified that the necessary consequence by which enhanced cooperation emerges is anchoring future deepened cooperation in many, or perhaps in all member states of the Eurozone. Outcomes could range from emergency bailout schemes for the East all the way to including the whole Union.

4.1.3. Re-imagining the Supply Side: multi-faceted Approaches

Assistance to the East could come instead from the Union's existing institutions, such as the Structural, Cohesion, and Social Funds. Although the current levels of funding are not sufficient for a large-scale bailout, they could be raised. The existing structure and expertise of the Funds are obvious advantages for tackling the considerable challenges at hand. Further assistance, for European banks as well as governments, could be coordinated through the European Central Bank, European Bank for Reconstruction and Development, and the European Investment Bank. These institutions also possess the necessary expertise to make effective loans, and being internationally governed, they are less likely to be influenced by protectionist sentiments, coddle national champions, or pursue pet projects. For governance, supranational coordination is deemed best, as common structural spending policies are already matters of the whole community. In context of enhanced cooperation within the realms of budgetary sustainability, fiscal coordination, investment stimuli coordination, and mutual bail-out guarantees, repercussions for existing policies of the Union like structural and agricultural policies should be considered.

Examining already existing spending and structural adjustment mechanisms, the common agricultural policy and structural funds are the most important ones. The common agricultural policy and the cohesion policy are the most important areas of cooperation in the current European Union. Together, these policy fields

account for 70 per cent of the EU's budgetary spending in 2009 (European Commission 2009d). The Common Agricultural Policy (CAP) has two pillars. The first pillar is financed by the European Agricultural Guarantee Fund (EAGF), which pays the expenditure on refunds for the intervention measures to regulate agricultural markets, direct payments to farmers, aid for diversification, and other forms of direct funding. In 2008, the EAGF payments summed up to 42,5 billion Euro, 88 per cent of which constituted direct aid to farmers. The second pillar is the "Rural Development Policy". The European Agricultural Fund finances Rural Development (EAFRD). In 2008, its budget consisted of 12,5 billion Euro (European Commission 2009d). The other structural spending instrument is cohesion policy, made up of two approaches: first, the traditional one, which is supposed to support the convergence of the least developed regions; and the second one, which is supposed to modernize the entire EU (Lisbon Treaty). The less-developed countries are not always pleased with the application of the policy. Spain and Ireland, who were formally recipients themselves, are now being asked to contribute to the cohesion funds for the new member states.

There is no necessary need for deepened integration to change the ways money is spent on structural policies, as political rationales enabling cooperation within the Union dominate patterns of spending. But there is a place for deepened integration in raising revenues, as it pertains to stability of the EMU. The introduction of a union-wide corporate tax would raise revenues beside government spending, levying the expenses of companies across the Union according to individual economic capability. This would create the benefit that distortions due to different productivities would be accounted for on a common European level, in fact offering opportunity to companies in weaker regions. A common tax base for the Union would also entail levying for short-term fiscal transfers between countries, as it comes to distribution, adding a further dimension both to structural adjustment and bail-out. Such a governance mechanism would strongly depend on the EMU's general governance institutions. Coordination between the Commission as executive and a new Eurogroup with legislative power seems necessary in such an environment.

Such a deepened European tax base also would weaken incentives for protectionism, in turn fostering competition. The creation of the Internal Market is clearly the greatest achievement of the Union, and competition policy is strongly cemented therein, leaving little doubt of its effectiveness. The Internal Market is not complete, however. In particular, the liberalisation in the trade of services has not nearly reached the level of free trade in the European goods market. The Bolkenstein Directive on Services (2006/123/EC) is set to enter into force in December 2009. The Directive has been considerably weakened from its original version, however; among other provisions, the „country of origin“ principle was removed, thus subjecting the entry of a firm into a new market to that market's national bureaucracy. Furthermore, protectionist and nationalistic provisions in recent rescue and stimulation packages as a result of the financial crisis have placed the Union's competition regime under significant pressure. A common European corporate tax would be a partial provision against building "national champions".

Since a common tax is very difficult to implement, and even if it existed, it would be insufficient to fully protect against protectionism, it would be better if the current allowances for statist intervention were either further tightened in order to preclude their market distorting effects, or flexibilized to allow for approval on a case-by-case basis (Dullien and Schwarzer 2005). The liberalization for the service market is a vital step for Europe to gain the benefits of increased employment and lower prices that the Single Market promises. Unfortunately, Germany and France have in the past proved their opposition to the Services Directive. Without the support of these major economies, such liberalization across the entire Union is impossible. The possibility of a 'service free trade zone' is conceivable, however, using the instrument of enhanced cooperation. The liberal market economies of Ireland and Great Britain would likely find willing partners in the economically open eastern European states. The accession of the Union's hesitant coordinated market economies could then follow at a later date.

4.2. Regulation of Financial Markets

The efforts to stabilize Europe's troubled periphery have not yet begun to address a further problem plaguing the continent, namely the region's struggling banks. Unlike the \$700 billion Troubled Asset Relief Program in the United States, Europe has not created a coordinated response to the issue of under-capitalized and non-lending banks (ECB 2008b; ECB 2009). In October 2008, Germany's finance minister dismissed a French-backed plan for a common fund to rescue banks. This has since led to a smattering of national bank rescue plans. A few so which, such as the British and Greek schemes, also carry a distinct scent of protectionism

in the form of 'lend domestic' expectations. A coordinated effort to refinance Europe's bank could accomplish two goals at once: aiding economic recovery by returning liquidity to credit markets and preventing a surge of protectionism, which fundamentally contradicts the principle of the Common Market (Speyer and Walter 2007; Trichet 2004). The need for a response is certainly clear, as Robert Zoellick, president of the World Bank, estimates that eastern European banks alone need 120 billion of fresh capital (Economist 2.26.2009). Following that huge sum in the short-term, the long-term challenge is to prevent a new crisis by improved regulation. For enhanced regulation in the field of financial markets, various fields come into perspective.

Field of Reform	Description
Securitization	Securitized assets have played a major role in the financial crisis because they make it more complicated to identify the existing risk and they separate the decision to issue a loan from the responsibility for the risk. Therefore, financial institutions should be constrained to bear at least 20 per cent of the risk themselves, leaving 80 per cent of the risk for securitization.
Shadow banking / off balance	Another problem shown by the financial crisis is the shadow banking system, which allowed banks to use special purpose vehicles off their balance sheets. In the future, those special purpose vehicles should be included in the balance sheet, enhancing transparency and the calculation of the individual and systemic risk.
Financial products and innovations (register)	To enhance transparency and to avoid new financial products that cause systemic risks, a European registration office for financial innovations should be introduced. This registration office would be in charge of standardization and simplification of financial products and limit the fashioning of financial products. It should serve as a first step to an international registration office.
Rating agencies	Improving transparency is also a task of the rating agencies. However, the rating agencies have contributed to the crisis due to the misleading ratings of some complex financial products like securitizations. Another problem is the combination of rating and consultation of those agencies, causing conflicts of interest and leading to neglecting the core task of rating. Those tasks should be clearly divided and a European agency to register and control rating agencies has to be established. Furthermore, the ratings should follow principles of sustainable management, which should replace the fair value principle, mark-to-market rules and the reporting of uncertain future returns in the balance sheet.
Hedge funds and private equity funds	Moreover, a lack of transparency is present at hedge funds and private equity funds because their data on business models, ongoing transactions, and ownership structures are in most cases not clear. Another problem is that they operate mainly with borrowed capital, so that they do not have an adequate capital base. To solve those problems, hedge fund management companies could be required to register before they can operate in the EU and a minimum capital ratio of target companies could be introduced.
Capital requirements	The capital requirements directives like Basel II consider too much the short-term principle and are inadequate in measuring the systemic risks caused by complex financial products. Therefore, these capital requirements should be reformed by introducing a limitation of bank leverage, minimum capital ratios for all credit risks and higher capital ratios for risky products as well as new financial products. Moreover, the off-balance vehicles should be limited, the period transformations should be better regulated, and the debtor of mortgage loans should be handled more strictly, e.g. requiring 20 per cent equity position of the debtor and a check of income and assets. To enhance the orientation towards long-term principles the bonus schemes for managers should be changed to a period of at least three years.
Offshore financial centers	Further challenges are the tax havens and the more or less regulation- and law-free offshore financial centers, which offer possibilities for financial institutions to elude regulation and foster tax flight and tax evasion. To put an end to those practices, joint action is required on EU-Level as well as on an international level.

Tab. 2 Financial Markets: Elements of Reform (FES 2009)

In November 2008 the European Commission set up a High Level Group chaired by Jacques de Larosière that was to work out recommendations for a reform of the European financial system.

According to the Larosière Group, there are several problems for banking regulation shown by the financial crisis. The first problem is a lack of adequate macro-prudential supervision, which criticizes that the EU supervisory arrangements emphasizes too much the supervision of individual firms. Secondly, there was no mechanism to translate identified macro-prudential risks into action, resulting in ineffective early warning mechanisms. Furthermore, the report identifies problems of competences shown by the mistakes made by supervisory bodies in the cases of Northern Rock, IKB, and Fortis. Failure to challenge supervisory practices on a cross-border basis is related to the problem of home supervisors' decisions affecting host supervision. Moreover, information flows are criticized because of a lack of frankness and cooperation between supervisors. Further, problems are caused by unequal power of national supervisory bodies related to their ways of supervision and to the possible enforcement actions, such that there is a lack of consistent supervisory powers across member states. Concerning the common decision-making at the level 3 committees, the report disapproves a lack of resources in the level 3 committees and that there are no means for supervisors to make common decisions, which results in an ineffective mechanism for enhancing and strengthening cooperation between the national supervisory authorities (Larosière Report 2009: 39-42).

To strengthen the macro-prudential supervision, the Larosière Report recommends a new institution called European Systemic Risk Council (ESRC), which should pool and analyze relevant information for financial stability and about macro-economic conditions and developments. This new body should be chaired by the ECB President and should be composed of members of the general Council of the ECB, the chairpersons of CEBS, CEIOPS, and CESR, as well as one representative of the European Commission. Related to the ESRC and to the Economic and Financial Committee (EFC), an effective early warning system should be developed with a direct line to the relevant competent authorities in the EU (Larosière Report 2009: 46).

Pertaining to the micro-supervision, the proposal suggests putting a European System of Financial Supervisors (ESFS) into place akin to the European System of Central Banks. This two-stage approach ensures that supervision would be close to the financial markets and institutions by leaving the most parts of day-to-day supervision at the decentralized national level. Further, the supervision of major cross-border institutions should be assigned to colleges of supervisors.

At a central European level, the level 3 committees should be transformed into three European Authorities: a European Banking Authority, a European Insurance Authority, and a European Securities Authority. Those new bodies composed of the chairs of the national supervisory authorities should be strengthened in comparison to the current level 3 committees. Furthermore, they should be independent of political authorities, but accountable to them. Among other things, their tasks should be a) legally binding mediation between national supervisors, b) adoption of binding supervisory standards, c) the oversight and coordination of colleges of supervisors, and d) licensing and supervision of specific EU-wide institutions like Credit Rating Agencies, and post-trading infrastructures. As a result, there should be a common high supervisory standard, a strong cooperation between the different supervisory bodies and similar rules, powers, and sanctions of national supervisors. However, it is not a goal to fully harmonize all national supervisory structures (Larosière Report 2009: 44-56).

A counterproposal would be to establish only two institutions: One for supervision and one for market conduct (Goodhart 2009: Masciandro and Quintyn 2009). Furthermore, a single new institution could be established, a European Financial Authority (EFA), leading to a twin peak structure of ECB and EFA monitoring a two-level system, comprising a federal level and a state level (Masciandro 2009). Moreover, an effective European crisis management would only be possible with a fiscal back-up. Otherwise, every attempt at European crisis management could be subverted by national bodies, resulting in financial protectionism (Goodhart 2009; for further discussion see Buiter 2009).

5. Outlook

5.1. Persistent Challenges

Since the 16 Euro members have given up their monetary policy to the ECB and limited their freedom of fiscal policy under the SGP, diverging trends of macroeconomic performance have emerged. Whereas the Germany economy managed to reduce its wage unit costs since the introduction of the Euro, Italy, Spain, and France have seen an increase of 15-20% (Schwarzer 2009: 19). This has led to the accusation of German „beggar thy neighbor“ policies and political tensions between these major Euro zone economies (Becker 2008a). This kind of tensions is likely to increase. Before the introduction of 12 new members into the EU since 2004, the monetary policy of the Euro area was in the competent hands of the ECB and there was less of a need for an executive governance body, since 12 of the EU's 15 members at that time were Euro countries. Matters of economic governance could be addressed relatively effectively by the European Council and the Economic and Financial Affairs Council (ECOFIN). This has since changed since the expansion, leaving the Euro zone without either an official forum for economic policy or a dominating majority within the EU's institutions.

Further concerning the Euro, the dramatic movements of the common currency against the yen and dollar, downwards following its introduction in 1999 and strongly upwards from 2005-2008, have caused difficulties for the economies of the Euro area. Unlike other nation-states, the EU does not have a clearly defined exchange rate policy, nor does it have an effective mechanism for implementing one. Concerning an exchange rate regime for the Euro, it would be possible to modify the current governance structure of the ECB allow it to intervene in financial markets on the Euro's behalf, acting on a decision from the Council.

The incompleteness of the Internal Market is a further hurdle for effective economic governance in Europe. The groundwork is in place in EU law for the Commission and the ECJ to combat the protectionist tendencies of the member states. It would be better, however, if the current allowances for statist intervention were either tightened further in order to preclude their market distorting effects, or flexibilized to allow for approval on a case-by-case basis. Furthermore, the liberalization for the service market is a vital step for Europe to gain the benefits of increased employment and lower prices that the Single Market promises. Unfortunately, Germany and France have in the past proved their opposition to the Services Directive. Without the support of these major economies, such liberalization across the entire Union is impossible. The possibility of a 'service free trade zone' is conceivable, however, using the Instrument of Enhanced Cooperation. The liberal market economies of Ireland and Great Britain would likely find willing partners in the economically open Eastern European states. The accession of the Union's hesitant coordinated market economies could then follow at a later date.

The future of economic governance in Europe must address these issues, especially in these current times of economic hardship. If the EU does not muster an effective policy response, the Union will literally drift apart along national lines and could ultimately disintegrate. More important, however, are the possibilities of coordinating a more effective response to the crisis internationally than any single country could produce alone.

5.2. Future Faces of the European Polity

There are different conceivable possibilities for an economic government to define the relationship between state and market (Boeri 2002; Mathieu and Sterdyniak 2008). As diverse economic models and hence different political approaches to comparable problem areas prevail in Europe, the most influential states might finally shape the orientation of a future economic government according to their own models and preferences. The literature offers diverging views on whether a certain path dependence results from the distinct structure of a national economy (Berger; Dore 1996; Sapir 2005) or whether, on the contrary, the different models are bound to converge in the long run. In general, two streams judging these European differences can be identified. The first focuses on the evaluation of economic competitiveness and of the institutional structures for economic growth and employment. Hall and Soskice (2001) classify liberal and coordinated market economies. The second stream seeks a better understanding of different welfare regimes. Here Esping-Andersen (1990) established the typology of liberal, social-democratic, and conservative (continental) welfare regimes in Europe. Both approaches analyze the influence of institutional arrangements and of the degree of state intervention on

economic performance and redistribution mechanisms in the sub-systems of the national economies. As a result, a tension between meritocratic-hierarchical principles and egalitarian-humanistic principles (Wilensky 2002) can be recognized as driving market development and defining political action.

Previous analysis has shown that closer cooperation is necessary to cope with the concurrent challenges of the economic downturn, different capabilities and productivities within the the currency union, and possibly diverging policy responses in the form of protectionism. Given the need of an European economic government, or at least increased economic governance among member states, the old question of what to do with this is raised anew. From the considerations above, three distinct scenarios can be drawn: (1) Ordoliberal Europe, (2) Social Market Democracy, (3) Socialist European Democracy.

Probably the oldest market theories is that of the free market economy (c.f. Hayek 1960; Friedman 1962). The free market is characterized by an almost complete absence of governmental intervention since it is controlled by the “invisible hand”, which Adam Smith had already described in 1776. Production and consumption of the basic entities, companies and households, develops along the fundamental principles of supply and demand. The only task of the state is to assure the principle of ownership and to guarantee working market regulation, for example maintaining free competition and contractual rights. In the scenario of Ordoliberal Europe, the European Union maintains its role as strong regulator and market supervisor, but refrains from drawing fiscal measure and transfers within the Union. This mode of economic governance entails a prolongation of status quo policies and abstains from the idea of a common economic government with redistributive capabilities. Decision making entails a high degree of sustainability.

The scenario of Social Market democracy creates the basic need for a central European redistributive agency, possibly with the power to raise its own taxes and distinctive fiscal transfer mechanisms. The role of this agency would be to stabilize the markets and ensure its welfare effects for all Europeans, as in the conservative welfare states on the European continent. Here, the basic unit of society is still the family and to a lesser extent the individual. Therefore, conservative welfare states provide fewer comprehensive social rights linked to employment on the one hand. On the other hand, it offers a higher level of protection against class, life-course, and intergenerational risk.

The opposite of a free market economy is a relatively strongly regulated system with a big welfare state. Here, the government undertakes many measures for enhancing the social welfare of its citizens and for providing the highest possibly living standard. Therefore, the state intervenes directly in the economy, aiming to establish an economy which serves the community and establishes “social justice” and “equality”. Not only the level of regulation but also the real paid benefits are high in welfare states. In these countries, the public spending ratio is over 50 percent (Deutsche Bank Research 2006: 13). In this scenario of European Socialist Democracy, central coordination would be enacted, as well as state intervention in the markets for the sake of societal goals like full employment, income equality, and social justice in general. This last form of economic governance demands the highest degree, of not only economic but also of political integration.

6. Conclusions

Analysis has shown that deepened integration and enlargement demand increased cooperation among the European member states. This is due to the fact that, in the face of imminent challenges on the one hand and domestic strains on the other hand, European coordination would create benefits for all, especially in an enlarging Union. The mode of governance employed for deepened cooperation varies between supranational, intergovernmental, and flexible forms of cooperation, depending on the sort of challenge, existing institutional frameworks, and the capability to be enhanced. The specific instrument of enhanced cooperation seems unfit in most cases, due to the high restrictions for application of this policy tool. Nonetheless, broader forms of deepened integration on an informal base seem best fitted to cope with economic demands and political constraints as well as diverging national interests. They envision centripetal forces of front-runnership, inducing new members towards future membership, and deepened integration.

In the long run, the challenges of uncoordinated fiscal policy in Europe become more numerous and more complicated. In simple terms, the spending decisions of member states have effects on their the gradual economic development. Over time, this can lead to comparative disadvantages, which in turn decreases European consolidation and increases political as well as economic tensions. For example, deficit spending

increases government debt and eventually constrains the country's ability to respond to future challenges. Particularly in light of shrinking and aging populations, indebted countries will face increasingly unpleasant options to meet their obligations, such as cutting pensions, increasing taxes, or reducing debt burdens via inflation or default. In a further regard, current spending decisions also effect the long-term growth potential of a country. The more a government invests in the future, such as education or research and development spending, the greater the growth potential of the country becomes. This fact has long been recognized in Europe, for example leading to the Lisbon Strategy goal of spending 3% of national GDP on research and development. Unfortunately, this goal has never been reached. Governments generally struggle to gain public support for spending programs that promise results only in the future. In these regards, Europe could again benefit from a coordination of fiscal policies. In particular, binding mechanisms to require governments to consolidate their finances in good times and to invest in long-term growth potential would contribute greatly to European economic and political integration.

Enhanced cooperation on a broader scale is only a first step. Growing economic divergences and political conflict within the Union might still endanger future European integration. A fundamental solution for a global European system of economic governance, covering short, medium, and long-term policy tasks is still out of reach. However, there are core areas and institutions whose build-up in times of crisis and pressuring challenges might offer the beginning of such a fundamental solution.

7. Appendix

7.1. European Economic Governance – State of the Art

As in any economic system, European economic governance comprises institutions for monetary, fiscal, and structural policies. Regarding economic coordination, the legal foundations have been laid by the treaty of Maastricht, with changes in the treaty of Lisbon. For governing the EMU, there are two major instruments: the Stability and Growth Pact (SGP) and the Lisbon Agenda, including the Broad Economic Policy Guidelines.

The creation of the Euro area within the European Union (EU) certainly would not have been possible without the support of the traditional motor of European integration, Germany and France. It is surprising to note, therefore, that the institutionalization of the new currency followed a clearly recognizable German pattern, with little European or even French influence. The European Central Bank (ECB) was fashioned after the German Bundesbank, including complete political autonomy and a single mandate to control inflation. The SGP was adopted in 1997 following German insistence, as its low-inflation policy was seen as having contributed to Germany's strong economic performance in the post-war period. The SGP's requirements for budget deficits of no more than 3% of national GDP and national debt of no more than 60% of GDP were intended to prevent the possibility of lax economic policies 'free riding' on the common currency and raising inflationary pressure, even for fiscally conservative members. Exceptions to the criteria were only allowed for natural disasters or an economic crisis in which national GDP recedes by at least 0.75%. Consistent breaches of the criteria were to lead to sanctions from the Commission, the proceeds of which were to be distributed to the other member states to at least partially compensate them for the macroeconomic costs of the malefactor state's impropriety.

This Teutonic flavor certainly resulted from the Bundesbank's historical success at constraining inflation, as well as the other European countries' lack of credibility following decades of mediocre fiscal performance (Strassel 2009). Nonetheless, France has never ceased to desire further instruments of economic governance for the Euro area. On the one hand, this represents a French desire to counterbalance the ECB, and on the other, a continuation of typical French statist guidance of market forces. The SGP has often been criticized for its inflexibility and has been reformed in 2005, introducing more political discretion, other rules for "a steep fall in GDP" (Begg 2008), and other comparable measures.

Before the introduction of 12 new members into the EU since 2004, the monetary policy of the Euro area was in the competent hands of the ECB and there was less of a need for an executive governance body, since 12 of the EU's 15 members at that time were Euro countries. Matters of economic governance could be addressed relatively effectively by the European Council and the Economic and Financial Affairs Council (ECOFIN). This has since changed since the expansion, leaving the Euro area without either an official forum for economic policy or a dominating majority within the EU's institutions.

The need for economic governance in the Euro area has led to the creation of the Eurogroup in 1998, an informal but influential forum consisting of the economic and finance ministers of the 11 Euro countries at the time, as well as representatives from the European Commission and ECB. The Eurogroup generally meets directly before the official ECOFIN sessions to coordinate a unified position for the Euro countries. Since 2005, the group has elected a president for two and a half year terms to represent the group publicly. The Treaty of Lisbon, if ratified, would recognize the Eurogroup and its president officially, calling it the Euro-ECOFIN-Commission. The group would maintain its informal nature, however, and have no power to enforce any of its decisions.

In 2003, the Council began issuing Broad Economic Policy Guidelines (BEPG) as a link in coordinating the Member States' economic policies. Under Article 99 of the EC Treaty, the Council can accept recommendations from the Commission, draft a report, and present it to the European Council. The European Council, acting on this report with qualified majority voting, adopts a set of guidelines for a three-year period (Europa 2009). The BEPGs have no legal force, but serve to „name and shame“ the undesirable practices of the EU's member states, seeking to achieve macroeconomic coordination through „peer pressure (Becker 2008a:34). In 2005, the BEPG were combined with the Employment Policy Guidelines to produce the Integrated Guidelines for Growth and Jobs. The Integrated Guidelines are formulated in the same way as the BEPG and are currently available for the period 2008-2010. In general, the Guidelines have had little effect, though, as the „peer pressure“ mechanism has proven to be a „dull weapon“ (Becker 2008a:34)

The competition policy of the European Union, enforced by the Commission and the European Court of Justice (ECJ) represents a final institution of economic governance within the EU. The creation of the Internal Market is clearly the greatest achievement of the Union, and competition policy is strongly cemented therein, leaving little doubt of its effectiveness. The Internal Market is not complete, however. In particular, the liberalisation in the trade of services has not nearly reached the level of free trade in the European goods market. The Bolkestein Directive on Services (2006/123/EC) is set to enter into force in December, 2009. The Directive has been considerably weakened from its original version, however; among other provisions, the „country of origin“ principle was removed, thus subjecting the entry of a firm into a new market to that market's national bureaucracy. Furthermore, protectionist and nationalistic provisions in recent rescue and stimulation packages as a result of the financial crisis have placed the Union's competition regime under significant pressure.

The need for more flexibility was first realized by relevant EU actors since the treaty of Maastricht (EMU). Subsequently, two strains of thought have dominated. First, ideas of enabling smaller groups of states to cooperate within the institutional framework of the European Union are canvassed particularly by France and Germany. On the other hand, countries such as Great Britain favour an à la carte flexibility, whereby smaller groups of member states should be allowed to engage in cooperation in specific fields of common interest outside the main EU institutional framework. Until now, the Franco-German way has prevailed and all existing forms of closer cooperation are encapsulated within the existing EU framework. However, the conditions for Enhanced Cooperation introduced by the Amsterdam Treaty were so rigid that almost no initiatives have developed.

There exists furthermore a link to the existing EU aims of the Lisbon strategy which demands an increase of R&D expenditures and to the current anti-cyclical economic stimulus plans on national and EU level which provide measures for the advancement of education (European Commission 2009d; Federal Government of Germany 2009). The social partners in Europe have also often expressed common interest for the promotion of qualification, training, and education for workers (European Trade Union Confederation, 2007 & European Association of craft, small and medium-sized enterprises, 2007). Especially trade unions have remarked in this context, that in addition to flexicurity measures, actions have to be undertaken which enhance economic growth (id.).

Human capital investments not only consist of expenditures that are made by the state or the European Union. In some cases they comprise investments made by the private economy. This has to be considered for certain areas of professional qualification, research and development, as well as for financial aid for advanced training and education in the tertiary sector (OECD, 2008). State and EU authorities have thereby the task to formulate guidelines for the market by giving for instance legal and financial incentives.

7.2. Employment and Labor Relations

The treaty of Amsterdam [1997] amended the treaty establishing the European Community by Articles (125-130) which provide a “coordinated strategy for employment” as a goal of member states of the Community (Streinz 2008). Employment policy is not an explicit EU competence; however coordination in this area without

regulations was expressed by the EU since the treaty of Maastricht and the subsequent currency union. The provisions of Art. 125 ECT can be seen as a practical case of the “open method of coordination” which concentrates since 2005 on employment policy.

The open method of coordination is in use in other European policy fields which are often closely related to employment policies [e. g. entrepreneurial policy or policies promoting research and development] (Hodson and Maher 2001). A broader approach is also favored by the proposals of the European Commission concerning the decisions of the European Council on the broad economic policy guidelines in connection with the European employment policy for 2008-2010 (European Commission: 2007a).

The open method of coordination is used as a term for those policy areas which are not affected by EU legislation (cf. consolidated version of the treaty establishing the European Community: Art. 129). In the area of employment policy, the existing EU-competence ranges from the formally granted freedom of movement for workers to regulations in certain areas of occupational safety and health, social protection, and anti-discrimination. The *de jure* far-reaching provisions of the treaties have not been utilized completely (Streinz, Rudolf, 2008: para. 940, 1091-1104). Nevertheless, certain directives concerning the harmonization of the freedom of services or the equal payment for women and men are of importance. The clause of Art. 137 para. 5 ECT excludes the areas of the right of association, the right to strike, the right to impose lock-outs, and any regulation concerning the collective payment of workers from all forms of coordination in the European Union.

Besides the special provisions for employment policy, several broader economic and social coordination methods exist in the European Union. Art. 99 TEU has introduced the periodical broad economic policy guidelines of the Commission, which address areas that are not affected by the common market and the monetary union (Streinz 2008). Since the decisions of the European Council of Lisbon in 2000, the open method of coordination is also implemented in the intermediate-term social policy [Lisbon strategy]. The “macroeconomic dialogue”, which was introduced in 1999 between EU-Institutions, national governments, trade unions, and employers’ organizations has merely consultative functions. It has not led to any important initiatives so far (Niechoj 2004). The reforms of the treaty of Lisbon, which has not been ratified until now, will not result in any significant institutional changes concerning the regulations on a European employment policy (Streinz 2008).

The open method of coordination, which consists of political convergence aims, timetables, benchmarking, promotion of best-practice-models, and the recommendation of national action plans is not legally binding (Hodson and Maher 2001). The procedure is embedded in the framework of the EU, whereas in most cases the European Council decides on a draft of the European Commission. Art. 125-130 ECT provides detailed procedural arrangements concerning a coordinated strategy for employment. Direct financial aid is furthermore possible for economically underdeveloped states and regions by means of the European social fund which is part of the EU budget. Via Art. 139 ECT, the social partners [trade unions and employers’ organizations], which have been recognized on the European level, have the additional opportunity to negotiate framework agreements which can be implemented in the national collective bargaining systems of the member states (Fuchs and Marhold 2006).

Reviewing the experience so far in the sectors of the Lisbon social agenda and its specific employment strategy, certain aspects of the European employment policy that are related to its “flexicurity” aims can only be improved in small steps implemented with the instrument of the open method of coordination (Sapir 2006). In this context, the term flexicurity is described by the Commission as a concept that on the one hand is composed of flexibility for labour markets by deregulation of employment protection legislation and that on the other hand is composed of security by the means of labour market integration, especially by training for workers and other supportive measures in the case of unemployment (European Commission 2007b). In particular, a harmonization of national security regulations in the sectors of employment protection legislation and of unemployment benefits would create considerable political opposition by the member states and by social partners in the EU (Keller and Seifert 2008). In the context of different welfare state traditions and different social models, many trade unions and employers’ organizations defend their national privileges in the area of labour market institutions. Additionally, it has to be seen that fiscal instruments for the labour market mostly remain a national competence (Sapir 2006).

These considerations are not refuted by the experiences since 2008. The far-reaching implications of the global financial crisis on the social and the labour market systems became apparent during the second half of 2008. The European Trade Union Confederation [ETUC] took action on this political field (European Trade Union Confederation 2009a). ETUC points of criticism and suggestions for improvement, citing i. a. the demand “to save capitalism from the speculators” by preventing layoffs, by guaranteeing social protection, and by annexing

a “Social Progress Protocol” to the European Treaties. They also called for a “New Social Deal in Europe” as well as for “greater transparency and better regulations of the markets”. In the actual crisis, ETUC sees “risks inherent to financial capitalism”. To counter “recession” in the view of ETUC, “coordinated actions and leadership” on the EU level is required. Corresponding proposals are included in the ETUC Declaration of 18 March 2009, directed to the European Spring Summit of March 2009 (European Trade Union Confederation 2009b). On the national German level, the “Konjunktur- und Wachstumsprogramm” (economic stimulus program) of the DGB [German Confederation of Trade Unions] pursues a similar policy (German Confederation of Trade Unions, 2008).

The various systems of welfare state cooperation of the member states are nevertheless important factors in some conflicts concerning the expansion of EU competence or certain proposals made by the EU commission. Great Britain, for example, has shown in the early 1990's resistance to an enlargement of EU legislation in the area of social policy. Tensions also became apparent in the recent criticism of social partners concerning recommendations of the Commission on common principles of the flexicurity concept. The European Trade Union Confederation [ETUC] has criticized these proposals for being too oriented towards the Danish model, with its extensive flexibility regulations for employment contracts, while neglecting other Scandinavian models which offer more security regulations. Furthermore, the ETUC has demanded improvements for the concept that include qualification measures for workers by “lifelong learning” (European Trade Union Confederation 2007). The corresponding proposals of some employers' organizations emphasize the necessity of independent national systems. However, they come to similar conclusions and demands concerning the qualification of workers (European Association of craft, small and medium-sized enterprises 2007).

A greater chance for a successful coordination could exist in areas which are closely related to a European employment policy. Coordination is accepted in the existing EU competence for product and capital markets or monetary policy. A consensus for a coordinated enlargement of the share of human capital investments in the areas of education, science, research, and development via the open method of coordination may also be possible. The positive effects of these measures for economic growth are broadly recognized by national states and stakeholders.

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Enhanced Cooperation and the European Foreign and Security and Defence Policy

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1. Introduction

The aim of the project as a whole is the study of the enhanced cooperation mechanism in the framework of the Lisbon Treaty. This contribution will focus on the Common Foreign and Security Policy (CFSP) and the Common Security and Defence Policy (CSDP).¹¹⁷

The concept of enhanced cooperation was introduced into the EU Treaty structure by the Treaty of Amsterdam, although this innovation is generally seen as an institutionalisation of previous ad hoc experiments in flexibility agreed within the Treaty framework at Maastricht with respect to Economic and Monetary Union, social policy and defence; as well as the Schengen Agreement, initially outside the EU Treaty system and brought into its structures also by the Amsterdam Treaty.¹¹⁸ Initially, however, the CFSP was excluded from the scope of the provisions on enhanced cooperation. The Treaty of Nice extended a limited possibility of enhanced cooperation to the CFSP, while still excluding from its scope all ‘matters having military or defence implications’ (Article 27b TEU). The Treaty of Lisbon, as well as expanding the Treaty provision on the EU’s Security and Defence Policy (currently Article 17 TEU), extending both its aims and its tasks and including a commitment to enhance its operational capacity, envisages a transformation of the ESDP into a *Common* Security and Defence Policy. It might seem paradoxical for the Treaty of Lisbon, at the same time as emphasising solidarity and the building of a common policy, to accept the extension of enhanced cooperation and flexibility into the defence sphere.

Indeed, one of the objects of this paper, as well as outlining the ways in which enhanced cooperation has applied to the CFSP (section II) and the ways in which this will be affected by the Treaty of Lisbon (section III), is to examine the extent to which foreign policy, security and defence lend themselves to enhanced cooperation and other forms of flexibility (section IV). The conclusion (section V) is that there is a need to distinguish between foreign policy and defence; the development of an active and credible EU foreign policy cannot readily accommodate differentiated integration as it depends for its force not primarily on either legally binding instruments or coercion but on political weight.¹¹⁹ On the other hand, military and defence capacities and initiatives are perhaps inherently differentiated. In order to explore these issues further we need to start by considering the rationale for enhanced cooperation more generally, and its application to the CFSP.

As one of the leading scholars of enhanced cooperation has pointed out,¹²⁰ there is a certain ambiguity in the rationales underlying the provisions on enhanced cooperation. On the one hand it is seen as a form

¹¹⁷ For a study of the possibilities of differentiated integration in EC external relations, and the impact of internal differentiated integration on EC external policy, not covered by this paper, see E. De Smijter, ‘The External Relations of a Differentiated European Community’ in B. De Witte, D. Hanf, E. Vos (eds.) *The Many Faces of Differentiation in EU Law* (Intersentia, 2001).

¹¹⁸ See generally D. Thym, ‘The Political Character of Supranational Differentiation’, (2006) 31 *European Law Review* 781; D. Král, ‘Multi-speed Europe and the Lisbon Treaty - threat or opportunity?’, *Europeum*, (<http://www.europeum.org/doc/pdf/895.pdf>)

¹¹⁹ As Daniel Thym has put it, ‘foreign policy is not primarily about statutory regulation, but about expressing political support, opposition, and pressure. The added value of European foreign policy stems from the combination of political clout and the strength inherent in united action’ D. Thym, ‘Reforming Europe’s Common Foreign and Security Policy’ (2004) 10 *European Law Journal* 5, at p.12.

¹²⁰ H. Bribosia, ‘Les Coopération Renforcées’ in G. Amato, H. Bribosia and B. de Witte (eds.), *Genèse et Destinée de la Constitution Européenne: Commentaire du traité établissant une Constitution pour l’Europe à la lumière des travaux préparatoires et perspectives d’avenir*, Editions Bruylant, 2007.