Executive summary

Overview

Following the crises of the last few years and the many resulting reforms, there is a potentially vast research agenda around the past, current and prospective economic governance system in Europe. Many established features of the European Union’s (EU) model of governance have been adapted or altered radically, some resulting in new challenges for a country like the United Kingdom (UK) which is not only outside the euro area, is but also unwilling to participate in new measures such as banking union. A resulting question is how much differentiation in economic governance is politically and constitutionally sustainable in the EU.

The urgency of crisis management has meant that the EU has appeared since 2010 to be in a permanent state of crisis management and has struggled to identify the best way forward. Yet there is an irony that the pace of reform has been frenetic, with the result that a policy framework likely to have pronounced effects on the politics and economics of the EU has been put in place, albeit with relatively little input from academic research, in contrast to that from the think-tank world. Although break-up of the euro is no longer the threat that some identified in 2011, an awkward research question is whether monetary union in Europe can be fixed or is inherently so flawed that it cannot survive.

Underlying the policy efforts to secure recovery is a broader policy question about whether a major paradigm shift is underway, akin to that seen when the post-war Keynesian model was eclipsed in the late 1970s. If there is one certainty, it is that a reversion to what preceded 2008 is unlikely. Hence, to borrow a phrase from Alan Blinder, ‘a new normal’ is to be expected although it remains to be seen what it will encompass. The ‘new normal’ can also serve as a useful rhetorical device for appraising the future shape of European economic governance, as well as the approach to key policy areas.

The evolution of economic governance has seen a number of changes in the roles undertaken by different actors, notably the European Central Bank (ECB), the European Commission and the European Council. Although there are sound reasons for these developments, they raise questions of legitimation and of how to hold these bodies to account. Despite calls for enhanced democratic oversight, it remains unclear how responsibilities will be divided between national parliaments, the European Parliament or, indeed, other possible means of exercising a legitimation function.

For the UK, the consequences of being increasingly remote from the core of decision-making in economic governance are unpredictable and often uncomfortable. There are
already concerns about the loss of British influence in Brussels and specifically about the potential impact on key sectors of the UK economy, such as the City of London. There may also be risks that other member states will tire of UK exceptionalism, with ramifications for the prospective renegotiation of the UK terms of EU membership and, subsequently, a possible referendum.

Main trends in research on EU governance

There is now a broad consensus among academic researchers that the original design of the euro was flawed, and there have been extensive efforts to understand the origins of the crisis and to assess whether the policy responses were well-conceived, timely and sufficiently comprehensive. Answers have been cautious, with many (especially from across the Atlantic) sceptical about the euro’s long-term viability. Some contributors to debates on what is needed have focused on the optimum currency area concept while others have looked more at the need for institutional changes and political processes to underpin governance mechanisms.

Across the developed economies, monetary policy has seen a profusion of innovations with resort to diverse forms of ‘unconventional policies’ historically low interest rates, and (latterly) the use of forward guidance to signal to markets. The ECB has become a much more influential actor in the course of the crisis as it has taken on substantial additional responsibilities and, arguably, has become a more complete and typical central bank. Similarly, the various roles in ensuring surveillance and discipline have given the European Commission a more intrusive role in national economic policymaking. In the architecture of policymaking, the European Council has gravitated towards a more explicit executive role, effectively, become the pinnacle of economic policy coordination and, to some extent, displacing the sectoral Council formations.

Unity and the community method have long been the preferred approach to EU law-making, but there has clearly been an increased willingness to accept that a sub-set of member states should integrate faster. In many respects, the euro area has become a core, but among the non-participating member states there are considerable differences in attitude and perspective. For the UK, especially, the fact that some leading non-members of the euro area are ready (indeed are often insistent on doing so) to participate in emerging governance structures such as banking union and the Fiscal Compact raises awkward questions about its influence and political alliances.

During the 2000s, there was extensive research on new modes of governance, particularly around the open-method of coordination, though this latter concept seems to have fallen from grace. Certain recent reforms, such as the advent of the European semester (which subjects EU Member States to a sequence of reporting to, and scrutiny by, the EU level) have altered the annual cycle of economic EU governance and are likely to shape the wider policy environment. In the process, existing coordination mechanisms (the open method) or strategies (Europe 2020, Sustainable Development) seem to have faded from view, although whether temporarily or not remains to be seen. More promisingly, the notions of informal governance and experimentalist have been used in the EU context to describe approaches which are distinct from more conventional inputs into policymaking.

One of the obvious shortcomings in economic governance over the course of the euro crisis has been the paucity of true leadership, with Germany reluctant to assume a
hegemonic role, the Franco-German ‘motor’ spluttering and an erosion of the political clout of the Commission. To the extent that Germany, however reluctantly, has had to become a leader in economic governance, there are bound to be implications for the UK’s position in Europe.

The UK has made clear that it will not take part in a number of the new governance mechanisms adopted in response to the euro crisis, while remaining broadly supportive of their aims. This stance poses a number of challenges. For example, even a limited banking union which excludes the City of London could lead to tensions around European financial integration. Much has been written in the past around the democratic deficit of the EU generally, but new issues arise in connection with economic governance, because democratic oversight of the governance reforms of recent years has been acknowledged to be inadequate.

**Main gaps**

The debate around some of the governance innovations designed to shore up the euro has been intense, but far from conclusive. A key question today, with implications not just for the conduct of euro area policies but also for decisions to accede to the euro area at all, is whether the euro is responsible for a schism between creditor and debtor nations. The relative economic performance of the members of the euro area and of the EU as a whole has been a regular research topic, but there is now a new urgency to investigating how the growing gaps, particularly between north and south, can be accommodated and what they imply for the design and implementation of economic governance. For example, there are widely differing views on whether or how debt mutualisation or some form of debt relief could be introduced. Questions also arise around the exercise of power on fiscal matters.

The interactions between markets and policymaking offer a range of research opportunities. Why were market assessments, including those of ratings agencies so flawed and was there a reaction after the euro crisis broke which amounted to over-correction/reaction? There is a linked question around whether markets have aggravated the crisis and, if so, what a governance response might be. Apart from the mispricing of risk in sovereign bond markets, hindsight shows that credit growth was a source of instability, as easy credit conditions from the windfall gains of euro credibility exacerbated imbalances. Today, the problem lies as much in a lack of credit and fragmentation of the European financial area. Light touch regulation of financial markets has been blamed for financial excesses, especially in the UK, but despite reforms of financial regulation and prudential supervision, how much heavier the touch should be or how best to deal with issues such as bonuses remains unsettled.

Banking union has been identified as essential to enable the euro to function effectively and is an area where major changes have been agreed in the last year, but there is widespread concern that what has been agreed is too limited. Together with interventions such as Draghi’s ‘whatever it takes’ and the creation of an instrument which has so far not been used in outright monetary transactions (OMT), the role of communication in monetary policy has evolved rapidly and could be a facet of economic governance worthy of more intense research, including in other policy domains. There are also significant challenges for the UK which has made it clear that it will not participate in banking union, but is adamant that the position of the City of London has to be safeguarded. What happens next, not least in the wake of the reviews of banks’ asset quality and stress tests on their resilience, due to
be made public in autumn 2014, can be expected to raise new issues around financial
stability.

Austerity, as the increasingly dominant governance paradigm, has come in for extensive
criticism. Is the criticism justified and how should its determinants be analysed? ‘Austerity’
understood as consolidation of public finances is not, however, an accurate description of
the policy prescription emanating from the EU level. The relationship between success in
the euro and structural reforms is a pivotal, though complex issue which warrants further
research.

Conclusions and recommendations

EU economic governance has been in flux in recent years and it is far from clear whether
the many reforms will achieve their goal of making the euro robust and resilient. There is a
growing body of literature which sheds light on these questions, but which could benefit
from being brought together more systematically and from further analysis. Research might
look at how and in what form EMU could be nudged towards enhanced optimality, including
through new approaches to financial market regulation and oversight. A fresh look is also
warranted at the theoretical bases for the assignment of competences and powers.

Several more specific governance challenges arise around different facets of running EMU,
including growing pressure on governments to come up with much better frameworks for
the governance of fiscal policy, suggesting a number of areas for research. These include,
how fiscal transparency evolves, the design of fiscal rules and the appropriate constitutional
framework for fiscal policy as the EU level's surveillance becomes more intrusive. The
interactions between markets and policymaking have been examined in different ways, but
also offer a range of research opportunities, including around the future nature and style of
financial regulation.

The EU's economic governance model is one based increasingly on executive than
representative power and the need for enhanced democratic legitimation and accountability
has been acknowledged in proposals from the Commission and the European Council for
genuine economic and monetary union. Where this leaves the European Parliament, let
alone national parliaments, in the governance firmament is a potential research question. A
specific facet of legitimacy is how to justify the often onerous conditions imposed on
national governments, around which national parliaments have little say. While there is no
shortage of academic thinking on these issues, no clear solutions have emerged and it would
be worthwhile to build on some of the work in this area. For example, the promising
concept of ‘throughput’ legitimacy has been put forward as a means of explaining the need
for oversight of how decisions and edicts are formulated inside the ‘black box’ of new
governance procedures.

A research question behind these developments, posed repeatedly in the UK, is whether
the institutional mix and balances of powers and competences in the EU are well-conceived.
New insights are emerging on this, including from the UK’s Balance of Competences review
and similar exercises undertaken in other member states. But these are long games and it
remains to be seen where they end, suggesting an open research question.
With the debate on continuing UK membership of the EU now fully engaged, there are several dimensions of the UK role in Europe in relation to economic governance on which new research could be fruitful. Research themes might include the following:

- The costs and benefits for the UK of the abstention from many of the governance mechanisms recently introduced have been asserted rather than quantified. What are they and under what scenarios will there be a net advantage for the UK?
- Will moves towards closer euro and euro-plus governance increasingly leave the UK isolated and with diminished influence; and, if so, with what consequences, including for the City of London?
- How tolerant will other member states be of British exceptionalism in economic governance and what impacts will any backlash have on the UK’s overall position in the EU and the referendum debate?