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EDITORIAL

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Faith in the process and progress of Economic and Monetary Union (EMU) has been deeply shaken, since 2008, by the myriad crises plaguing the European Union, and the euro area in particular. Is the governance of EMU, as it has been conducted to date, genuinely sustainable? Is it really equipped with the requisite means to foster convergence among the participating economies? If not, is it able to accommodate the presence, within its midst, of divergent trends? Does it truly possess instruments that can be effectively deployed in the event of crisis? Is it possible for the single currency to thrive in the absence of greater political and economic integration? These are some of the questions being asked.

We will not be arguing here that the causes of the manifold crises currently affecting Europe – financial crisis, economic crisis, private debt crisis, public debt crisis – are actually inherent in the architecture of economic and monetary union. What we will be pointing out, however, is that the architecture in question was clearly not devised and planned with the prospect of such shocks in mind.

Nor are the features of the current debate surrounding EMU in any way new. In the literature of the 1990s – i.e. the period surrounding the signature of the Maastricht Treaty (1992) – we find analysis of EMU and political union, of the need (or otherwise) for monetary union to be accompanied by European economic government, of convergence of development levels, and also of the potential impact of EMU governance on national social policies, collective bargaining, wage and price developments, etc. (Jacobi and Pochet, 1996).

Rather astonishingly, all this research seems to have fallen into oblivion at the end of the 1990s. To the extent that the successful launch of monetary union in 1999 was accomplished during a period of cheap and easy borrowing, the questions about the political, economic and social governance were assumed to have lost all relevance. The most optimistic commentators were even of the opinion that introduction of the euro would alone suffice – via the play of the market – to foster an ever increasingly optimal monetary area. Today, with the benefit of hindsight, we see that this was not the case. And the euro crisis is forcing national and European leaders to resurrect these debates with, on this occasion, the obligation to produce results.

Against this background, this issue of *Transfer* sets out to contribute to the discussion. Its contribution will be a specific one, in that its particular focus will be the social dimension of the theoretical models. The analyses do not invariably converge, as we shall see in the pages of this issue, and yet the need for debate entailed by their divergence has gone very much unrecognized during the introduction, over the last two years and more, of the various instruments of a 'new economic governance'. Meanwhile, the institutional innovations have already begun to exert fundamental and far-reaching effects on the national political and policy scene – on the preparation of budgets, the implementation of reforms, etc. – as well as on the national social models.

The contributors to this issue are in agreement on a number of basic points. All show, for example, that the origins of the euro crisis cannot rightly be attributed to the fact that public finances had run seriously adrift. They explain that the reasons why this initially peripheral crisis subsequently spread and gathered steam are essentially structural. In other words, the way out of the crisis is not via more and increasingly severe budgetary restrictions but through a search for remedies to the structural problems. It is at this point, however, that the analyses begin to differ, and that the need for debate thus becomes apparent.

Differing models

A glance back through history reveals the existence of not a single but of several models for economic and monetary integration, evidence of which can be found, for instance, in the Werner report of 1970, the McDougall report of 1977, and the Delors report of 1989. These models are characterized, essentially, by differing and, in some respects, incompatible modes of governance. Relevant questions in this respect include the following. Is economic integration a prerequisite for, or a consequence of, monetary union? What is the proper role of public finances: are they to act as automatic stabilizers, to form an embryonic pre-federal budget, or will it suffice to ensure coordination of national budgets through the observance of rules and procedures? What role is to be allotted to the social partners? Is it their task to develop a European industrial relations system or should responsibility for labour policy and wage formation remain at the national level? As Amy Verdun shows in her contribution, while each of these different models has had its hour of glory, management of the crisis since 2007 has been hindered by the absence of a common vision among Member States as to the most appropriate form of action.

Though the ‘new governance’ that has been gradually taking shape since 2010 has extremely important implications for Member States’ social policies, virtually no attention has been paid to the role of the social partners. Accordingly, while Europe has come to exert a strong influence on pay bargaining at national level, as well as on public expenditure, the social partners have not been granted a more important role at the European level. In Amy Verdun’s view, there is a resulting need for their role to be strengthened and for some fundamental rethinking about the European democratic model to take place.

Differing theories

Discussion, it may more generally be pointed out, has focused essentially on three explanatory theoretical approaches to the operation of monetary union: the optimal currency area theory; the optimal control theory; and, lastly, the policy coordination theory. One fairly crude explanation of the crisis would thus be to state that the euro area is not an optimal currency area because it is characterized by excessive regional differences – in terms of prices, costs, productivity levels, economic development, and so forth. It would suffice therefore, in the context of this claim, either to ensure that it should *become* optimal – such being the purpose of the various processes such as the Lisbon strategy or Europe 2020, etc. – or to throw out those members that have caused it to be *sub*-optimal (Greece, at one extreme, and Germany at the other). According to this same hypothesis, the adjustment variables applicable in the case of asymmetrical economic shocks should be greater labour mobility and increased wage flexibility, or even financial transfers. Yet labour mobility and, above all, wage and labour market flexibility have nothing to do with the origins of the crisis. Nor is it possible, according to Waltraud Schelkle, to regard lack of competiveness as a central factor, for a non-competitive region or country is a poor region or country but not a bankrupt one. In short, the optimal currency area theory is, in Schelkle’s own view, quite useless for an understanding of the major challenges faced by EMU.

Another approach to the problem, known as optimal control theory, is what some have described as ‘the advantages of tying one’s hands’ – meaning that governments commit to the goals (i.e. those of price and exchange rate stability) that they previously failed to follow. According to this theory, the stability of the economy has to be entrusted to an independent central bank in order to prevent a situation in which politicians might be tempted to manipulate the play of the market for electoral ends. Unlike the theory of the optimal currency area, this theory entails supplying the euro area with precise instructions as to how governance of the euro is to be conducted. And it logically entails also the belief that one of the causes of the crisis must have been a failure to follow the rules (i.e. essentially failure to observe the Stability and Growth Pact). The solution, in accordance with the same logic, would be to devise more precise and stringent rules that would include automatic sanctions in the case of infringement as a means of avoiding any intrusion of political power in the manner of their application. This theory fails, however, to explain how strict observance of the 3 per cent deficit and 6 per cent debt limit would have enabled the crisis to be avoided; why Belgium has not been sanctioned by the markets given that it does not observe the public debt criterion; why weak inflation has not stabilized the euro area; why the crisis has particularly affected, in some cases, countries with strong growth and, in others, those with weak growth, sometimes those with healthy public finances and at other times those with severely unbalanced budgets, and so forth.

A third attempt at explanation, finally, places the emphasis on the need, in a monetary union, to ensure policy coordination as a means of dealing with the increasing positive or negative interdependences that are set up (development of trade, faster transmission of price increases). According to this theory, policy coordination will be beneficial for each state participating in the monetary union. The balance of current accounts, for example, can be more easily corrected if the correction is performed simultaneously by each partner. This is why the new Scoreboard for monitoring macroeconomic imbalances, introduced by the European Commission, highlights current account deficits as well as surpluses – though the surplus countries were politically opposed to this stance and the thresholds for imbalances are not symmetrical. What this does, in any case, show is that adjustments have to be made on both sides. Yet the policy coordination theory comes up against major difficulties with respect not only to the definition of the goals to be reached but also to their implementation.

These three theories advocate very different and indeed incompatible approaches to interpretation of the crisis and to ways of solving it. In Waltraud Schelkle’s own view, it is the policy coordination theory that, whatever its shortcomings, offers the most convincing arguments. Its implementation, she argues, however, has foundered on the failure to endow integration with an adequate budgetary dimension. In other words, it is a question of ascertaining not only what is economically desirable but also of assessing what is politically feasible.

Towards an impossible European government

And what if the project of economic and monetary union were itself a mistaken approach? Or if, as claimed by certain observers, particularly from across the Atlantic, it were sufficient to dismantle this project and allow the countries in difficulty the freedom to devalue their national currencies? The euro area, Iain Begg reminds us, is a monetary union and not a fixed currency system. This means that membership is not revocable, which is something the ‘Anglo-Saxon’ commentators tend to forget rather too easily. What is more, monetary union is not just a stage on the road towards the dream of a political union advocated by some naïvely idealistic European federalists; it has an economic rationale of its own. Monetary integration, by eliminating the exchange rate risk, can be a way of making monetary policy more efficient. But it also entails costs, one of which is the single currency policy, which will inevitably not – 'one size fits none'! – suit all countries at the same time. Either it will be excessively accommodating or else it will be too strict, so that other mechanisms will be required to restore equilibrium. At the beginning of EMU, it was believed that the budgetary discipline imposed on the members of the euro area would lead to endogenous convergence; but that did not happen. Today, with hindsight, Iain Begg considers the four major shortcomings of EMU to have been:

- the Stability and Growth Pact's failure to anticipate the difficulties that afflicted so many Member States (e.g. the erosion of competitiveness in the south);
- the absence or inadequacy of instruments to pilot the economy, alongside weak policy coordination;
- the Commission's lack of ability to play a pivotal role in the prevention of imbalances;
- shortcomings in the effective implementation of Stability and Growth Pact rules and medium-term strategies in the Member States.

As for the reforms adopted to date, some progress has been made in the direction of greater political union, even though the issues raised for democracy have been inadequately addressed and the new governance remains too exclusively focused on austerity. One of the problems with the EMU 1 rules was their implementation; and there is nothing to indicate that this implementation will be better under EMU 2. The basic question arising today is therefore summed up by Begg as follows: 'how to design relevant instruments so as to deter moral hazard, align incentives appropriately and prevent free-riding, while ensuring that the benefits in terms of lower financing costs and fiscal discipline are maximized'.

In the short term, effective policy coordination is the only way forward. In the longer term, the question will be how to distribute the burdens and the costs of crisis resolution within the euro area. Here, inevitably, as Begg points out, contests will 'pit taxpayers against bankers, debtor nations against creditors and tax "dodgers" against ordinary citizens'.

Interlinked macroeconomic imbalances

The current crisis in the euro area is also clear evidence that the significance of macroeconomic imbalances has been greatly underestimated. In spite of so much talk about the need for balanced public budgets, no one seems to have noticed that the balance in question was not a sufficient indicator for the sustainability of monetary union. Other indicators have meanwhile been put in place and today constitute a substantial component of what is referred to as the new European economic governance. But are the new indicators the right ones? Here too, the debate is still open.

It is today claimed, for instance, that one cause of the crisis is to be sought in the current account imbalances between the countries of the north and those of the south. According to Stefan Collignon, however, in a real monetary union – as distinct from a mere fixed exchange rate system – such imbalances do not constitute a problem. The reasoning according to which the Member States should finance their investment solely from local savings is, Collignon claims, quite wrong. In a monetary union what has to be examined is not the current accounts but the flows of financing and payments among sectors and countries, in which respect it is to be observed that too many loans supplied from the north have financed the borrowing required by the south, thereby contributing to the creation of imbalances. As a result, the north has become financially rich, while experiencing stagnant growth, while the south has speeded up its growth but accumulated its debt (which was only to be expected, given the drop in interest rates). When the crisis came, the north, which had reduced its wage costs, benefited from high-yield investment, while the south fell into depression.

The main lesson of this analysis is that macroeconomic imbalances must always be examined in terms of their inter-relatedness between countries and regions: 'Germany's virtue is the south's vice and if the south were to turn to virtue, it would have to push the north into vice.' The euro crisis is the consequence of non-coordinated decisions in the private and public sectors of different Member States, and of the absence of regulation of financial flows, for such regulation could have prevented the excesses.

The remedy for this situation would, it is said, be to strengthen the competitiveness of the southern countries. The problem here is, Collignon points out, that this competitiveness is principally measured on the basis of unit labour costs and that this form of measurement fails to take account of the productivity of capital. A synthetic indicator linking unit labour costs to the productivity of capital would thus be more helpful and more relevant. It is on the basis, what is more, of such a synthetic competitiveness indicator that collective bargaining could be most appropriately coordinated at the European level – and such improved coordination would substantially reduce the costs of monetary union.

What about changing economic policies?

The main responses to the crisis so far have been increased budgetary discipline and the avoidance of macroeconomic imbalance. Discipline of this kind, while it may prove useful in the short term, does not, according to Bob Hancké, deliver any long-term solution. In the attempt to understand the crisis, numerous explanations have been offered: the inadequate flexibility of labour markets in the southern countries; poor management of public finances; price increases and the bursting of property bubbles; lack of financial regulation and the dangerous errors stemming from its absence.

We have here therefore various types of explanation that resemble a jigsaw puzzle, except that the pieces do not fit together. In reality, as Bob Hancké explains in his contribution, any search for explanations at the national level will be unsatisfactory. An effort has to be made, rather, to understand the interactions among different European dynamics and their impact on the economy of the euro area countries. The structural problem is the divergence in competitiveness between two blocs of economies which have the same monetary policy but not the same collective bargaining system. This divergence is the result of a missing link: the coordination of wage policies. According to Hancké, there are in the euro area two major country blocs: on the one hand, Germany and its neighbours; on the other hand, the countries of the south. In the first bloc, there exist powerful employer and worker organizations which have fully developed collective bargaining systems. In the second group of countries, collective bargaining is less autonomous, and the role of the state more important, while the wage formation system is weak. And yet these two groups of countries share the same wage policy. Given that inflation levels differ between the two groups, the level of real interest rates will be higher in the first group and lower in the second. Monetary policy is therefore pro-cyclical: it will be accommodating for the countries that have high inflation levels and strict for those with low rates. This pro-cyclical dynamic is partially offset by a lower real exchange rate in this latter group of countries, a factor which strengthens its competitiveness and exports. While the competitiveness of countries with high inflation rates is being eroded, current account deficits are growing deeper.

It is thus that the two groups of countries will experience exactly opposite directions of development: the competitiveness of the former will improve at the same rate as that of the latter will deteriorate. In the absence of a centralization of wage and budgetary policies, the euro has served to push these two groups of countries in opposite directions.

What this means is that EMU must put in place two mechanisms: one, required to react against excessive divergence in inflation when it appears, would be a budgetary union and/or set of transfer mechanisms through which countries with strong growth contribute to those that are slowing down. An arrangement of this kind would moderate growth and inflation in the fast-growth countries, thereby reducing the increased divergence in current accounts. At the same time, it would pose an important problem of democracy. The second mechanism required, meanwhile, would entail that Germany and its neighbours rethink their national economic policies centred on massive exports to the rest of the euro area and come to adopt more Keynesian policies, at the risk of higher inflation.

What about social policy and the question of democracy?

The concluding article in this issue of *Transfer*, by Philippe Pochet and Christophe Degryse, focuses on two aspects: the question of democracy, on the one hand, and the issue of social policy responsibility on the other. These two aspects are not, however, really separate for, as Habermas has forcefully pointed out, the new European governance rests on an 'increase in the European executive power in the service of a European regime compliant with the markets and to the detriment of the autonomy of the national parliaments' (Habermas, 2012). The authors' argument is that this regime compliant with the markets ends up ultimately calling into question and jeopardizing the national social models.

The question of whether there is a need to develop a genuine European social dimension or whether the social policy responsibility should be left at national level, subject to the vagaries of liberal economic policy adjustments, is not new. Here the various theoretical models of European integration propose quite a range of different answers. In the 1970s monetary union was regarded as, necessarily, the culmination of a process of political, economic and social integration. At a later stage, the same monetary union was considered to be not the *consequence* of increased integration but, essentially, its *trigger*. Maastricht, finally, was intended to take a third route: that of monetary union in the absence of political integration. For governance purposes, the monetary union was to be endowed with a greater or lesser number of procedural rules to be observed by participant countries. These rules were initially enshrined in the Stability and Growth Pact and the Broad Economic Policy Guidelines.

This 'third way' implicitly entails two elements of belief. One is that monetary union will *automatically* produce convergence among euro area countries, the other is that this process will *necessarily* be accompanied by a deregulation of social policies, and in particular wage policies.

Yet with respect to this last point, the period 1995–2005 temporarily gave the lie to those central bankers and mainstream economists who believed that such deregulation went without saying, that it would happen quite naturally, so to speak. For the 1995–2005 period actually saw not only the conclusion of 'social pacts' in many countries, and the putting in place of wage policy coordination mechanisms at the intersectoral and sectoral levels, but also the launching, at the European level, of open coordination methods in the fields of employment, pensions, the fight against poverty, etc. Developments during this 10-year period thus caused it to appear likely that monetary union would in fact be accompanied by a *strengthening* of the coordination of social policies.

As from 2005, however, a range of different factors prompted the discontinuation of this 'social moment', after which the crisis of 2008 and those which followed in its wake exacerbated a process of the dismantling of social models. The reform programmes were, from this point onwards, remodelled and exploited by a series of strategic actors in control of the levers of power as a window of opportunity to make the European social model into the adjustment variable within EMU. Insofar as since mid-2012 Europe seems to have begun to enter a new stage of the crisis and seems to be taking the road of increased political integration, the authors' claim is that such integration will be sustainable only if it is the outcome of a democratic public discussion and debate.

The reader who makes it to the end of this issue of *Transfer* will have become more strongly convinced that a historic turning point has been reached and that it is up to us to choose which way we want to go. The need today is to find the most appropriate answers to a series of political questions which affect the very nature of European integration but which, for a long time, had been deliberately ignored, ever since, in the mid-1980s, European integration was relaunched by the completion of the internal market. And here it may be worth recalling a favourite image used by Jacques Delors to describe the process of European integration. Its nature, he said, was somewhat akin to riding a bicycle. In order not to fall off, you have to keep pedalling. However, pedalling might mean going round in circles, turning back to where you had come from, or simply riding indiscriminately and purposelessly in no definite direction. The essential question to be answered is, of course, what is your intended destination? It goes without saying that, on your way there, you will need to take time to repair whatever defects the bicycle might develop (i.e. alter the rules in force, the institutions in place). This is no minor undertaking, granted, but the hasty application of a provisional patch would merely serve to postpone until later the essential and enduring issues of structure and direction.

We hope that you will enjoy reading this issue of *Transfer* and find in it food for new thought.

Translation from the French by Kathleen Llanwarne

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Christophe Degryse, Maria Jepsen and Philippe Pochet

EDITORIAL

Les crises multiformes que connaît l'Union européenne et en particulier, la zone euro, depuis 2008, ont profondément bousculé les certitudes dans la construction de l'union économique et monétaire (UEM). Son mode de gouvernance est-il vraiment soutenable? A-t-elle réellement les moyens de