

# UPDATING THE EMU 143

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Samu Kurri

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DIFFERENTIATED ECONOMIC INTEGRATION IN THE EUROPEAN UNION



Samu Kurri  
Head of Division, Monetary Policy and Research Department  
Bank of Finland

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- The financial and economic crisis has reinforced the two-layer economic integration structure in the EU. Many of the new rules and structures created during the crisis have focused on a solution to the euro crisis and are thus euro area-specific.
- There is little evidence, however, that the situation would have dramatically changed compared to the Maastricht EMU. All of the changes are still in line with the basic idea that all EU countries will join the euro when they are ready to do so.
- One of the key questions in the near future is likely to centre on the contours of the euro area-specific decision-making, its relationship to the EU as a whole, and its institutions and procedures.
- Even if the Eurogroup remains ‘formally informal’, it has managed to transform itself into a de facto institution within the EU, and its role and weight is likely to increase rather than decrease.

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## Introduction<sup>1</sup>

As a result of the crisis, major steps have been taken in terms of European economic integration. If the deepening continues along the lines of the latest proposals, it is likely to increase the pressure for further economic and political integration. Thus, the nature of the Economic and Monetary Union (EMU) is already changing from a monetary union to a more genuine economic and monetary union, and could subsequently change further towards a deeper political union.

In the Maastricht Treaty and the treaties that have ensued, the underlying idea has been that all countries, with the exception of the UK and Denmark, will join the euro when they are able to do so. During the financial and economic crisis that started in 2008, this goal has been challenged.

The question raised in this briefing paper is to what degree the crisis has led to differentiated economic integration within the EU. To this end, the paper discusses how euro-specific the changes to the institutional set-up have been, and how permanent the change towards euro area-specific integration is likely to be. In so doing, the paper also discusses established and emerging differentiation in the governance of the EMU.

### EMU 1.0: The Maastricht EMU

The Maastricht Treaty (1992) transformed the European Community into the European Union. The objective of the Treaty was to address five key goals: to strengthen the democratic legitimacy of the institutions; improve the effectiveness of the institutions; establish economic and monetary union (EMU); develop the Community social dimension; and establish a common foreign and security policy.<sup>2</sup> As mentioned above, in the Maastricht Treaty and the treaties that have followed, the underlying idea has been that all countries, apart from the UK and Denmark, will join the monetary union when they

are ready to do so. Thus, the (economic) integration in the EU has adopted a two-layer structure.

In the Maastricht Treaty, EMU economic policy consisted of three components: coordination and surveillance of national economic policies, financial and budgetary discipline, and common monetary policy. However, during the Treaty negotiations, the member states were unable to agree on the deepening of the economic part of the EMU. Instead of a true Economic and Monetary Union, the EMU started out mainly as a Monetary Union. As a result, the European Central Bank (ECB) did not have a fiscal counterparty in the institutional set-up. Fiscal policy, as well as banking supervision and resolution, were left to the member states.

The institutional framework of the EMU on 1 January 1999 consisted of three main pillars:

- A common monetary policy run by the Eurosystem (formed by the ECB and national central banks)
- A stability and growth pact to avoid excessive deficits
- A no-bailout rule

In terms of EMU governance, the differentiation established by the single currency was mainly manifested in the field of monetary policy, with the autonomous European Central Bank at the centre of monetary policymaking. Although it had some implications for the connected fields of the EU's macro-economic governance, it did not lead to significant spill-overs. Thus, the resulting evolution of differentiation in the EU's macro-economic governance remained limited and non-linear.<sup>3</sup>

Nor did the limited degree of differentiation propel a strong euro area-specific governance structure. Indeed, the limited character of differentiation has been reflected in part in the legal authority of ECOFIN, rather than in the Eurogroup in EMU governance.

1 The views expressed are the author's own and do not necessarily reflect the views of the Bank of Finland.

2 For more on this, see Europa. Summaries of EU legislation. [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/treaties\\_maastricht\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_maastricht_en.htm).

3 Dyson, Kenneth (2010): "Euro" Europe: "Fuzzy" Boundaries and "Constrained" Differentiation in Macro-Economic Governance', in Kenneth Dyson and Angelos Sepos (eds) *Which Europe? The Politics of Differentiated Integration*, Palgrave: Basingstoke: 215-32.

## Economic governance tightened as a result of the crisis

Even in the early 2000s, it became clear that the member states were lacking the political tools to implement the stability and growth pact, while the policymaking tools available at the EU level to ensure compliance were proving inadequate. Furthermore, when the financial and economic crisis that started in autumn 2008 morphed into the sovereign debt crisis, the challenges multiplied.

The major cause for concern over the sovereign debt crisis in the euro area was contagion, namely that the crisis would spread across the region and the euro countries would fall one after the other like dominoes. Therefore, the steps taken in economic integration have concentrated on the euro area. On the one hand, the focus has been on crisis policies, for example on building “firewalls” to stem the contagion between countries, or between banks and sovereigns.

At the same time, much effort has been exerted in the further development of economic governance in order to motivate countries to improve their economic policies and structures, with the goal of extricating themselves from the crisis and diminishing the probability of one in the future. The steps taken so far have increased the differentiation in the economic integration of euro and non-euro EU countries. However, it would be premature to claim that the steps taken would have changed the Maastricht principle of one EMU as a goal.

The tighter integration is due in part to Articles 136 and 137 in the Lisbon Treaty (2009), which allow the euro countries to agree on stricter rules of economic policy and to institutionalize the existence of the Eurogroup as an informal sub-group of ECOFIN.

Another avenue for deepening economic integration has been intergovernmental treaties. The Treaty on Stability, Convergence and Governance is open to all EU countries, but is designed to bind the euro members in particular. The permanent crisis fund, the European Stability Mechanism (ESM), is in turn open only to the euro countries

Some changes affect both the euro and non-euro countries, even in the event that the latter decide not to join the new body for economic governance. The Single Supervisory Mechanism (SSM) for bank

Chart 1: The 2 x 2 matrix of new economic governance

		EU legislation	Intergovernmental treaties	
EA17		2-pack	Euro Group	
				ESM
EU28		6-pack		
		SSM, SRM	TSCG	
			Euro Plus	

supervision is an example of this. The SSM is open to both euro and non-euro countries, but only the latter have the option of not joining. However, if a country that decides to stay out has a banking sector operating in other EU countries (like Swedish or Danish banks have in Finland or Estonia), the subsidiary will be supervised by the SSM if it is large enough to pose systemic relevance.

The new legislation and treaties, together with the proposals under discussion, are shown in Chart 1. In the chart, the new legislation or treaties are mapped onto a 2 x 2 matrix. If the innovation only affects euro area countries (EA) and is part of EU legislation, it is located in the upper left panel of the matrix. If the innovation only affects euro area countries, but is based on an intergovernmental treaty, it is located in the upper right panel of the matrix. Similarly, cases open to all EU countries (EU) are located either in the lower left or lower right panel of the matrix, depending on whether they are based on EU legislation or not. A grey zone in between the four panels indicates a mixed case. The different elements of new economic governance will now be discussed in detail.

### *Euro area-specific rules*

In addition to Articles 136 and 137 in the TFEU, the most clear-cut examples of euro area-specific innovations are the two-pack legislation and the European Stability Mechanism.

The two-pack legislation, which consists of two regulations<sup>4</sup>, complements the six-pack legislation. The first regulation obliges all euro countries to provide more precise and timely information on their fiscal policy outlook, especially on the budgetary process. The information requirements increase when the economic situation worsens, especially if a member state is undergoing the excessive deficit procedure. The second regulation describes the information requirements in a situation where a member state is in serious financial difficulties or is facing the threat of such. In these cases, the requirements are even greater. The two-pack came into force in May 2013.

The permanent crisis fund, the European Stability Mechanism (ESM), was inaugurated in October 2012.<sup>5</sup> It is an inter-governmental financial institution under international law. The funding capacity of the ESM is based on equity capital and the shares in this capital are calculated using the ECB's capital key. As already established above, only euro countries can be members of the ESM. When a country joins the euro, it will become an ESM member with full rights and obligations.

As regards EU governance, one aspect of the grey zone is the role of the Eurogroup. Its official role is informal, while formal decision-making takes place in ECOFIN. However, as the Eurogroup meetings are well prepared, the group has a president, and the meetings are held regularly just before the ECOFIN meetings, its role is de facto larger, especially when it comes to euro-specific issues such as deciding financial sanctions. It can also play a major role in other (euro-related) issues, as a majority of council members are likely to have already discussed a topic and could, at least in theory, have reached a consensus on it.

#### *EU legislation in the grey zone between euro-specific and EU-wide*

The new EU legislation in the grey zone between euro-specific and EU-wide consists of the six-pack legislation from December 2011, and the proposals on the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).

The first major step in improving economic policy coordination after the crisis in the euro area was the six-pack legislation. It can be partially seen as a tightened version of the SGP, as well as a new macroeconomic imbalances procedure, which widens the economic surveillance from public deficit and debt to imbalances in the general economy. The six-pack entered into force on 15 December 2011.

The new rules of the six-pack apply to all EU countries. However, the tightened rules in deciding financial sanctions are used only in the case of euro countries. Thus, the new rules are de facto more binding for the euro countries.

The SSM and SRM mark two major steps towards a banking union, which should help break the vicious circle between sovereigns and banks. One major lesson drawn from the crisis has been the deep and far-reaching interconnectedness of sovereign and banking risks. On the one hand, the collapse of the oversized banking sector has dragged state finances down with it. On the other hand, banks located in countries with doubtful economic fundamentals have been knocked out of the interbank markets.

The SSM is open to all EU countries and membership of it is a prerequisite for SRM membership. It is as yet unknown how many non-euro countries will join. Non-euro countries have voiced concerns about their influence in the SSM. According to the regulation, the euro and non-euro members will have an equal role (one member, one vote in most cases) in the decision-making body (supervisory board), but the Governing Council of the ECB will exercise a veto on that decision. Moreover, as the current structure includes the ESM as a direct recapitalization tool, the structure could be construed as being deeper for the euro countries, and therefore as fostering differentiation.

#### *Intergovernmental treaties that affect both euro and EU countries*

The first step in the intergovernmental agreements was the Euro Plus Pact<sup>6</sup> in March 2011, which was

4 Proposals (2011/821) and (2011/822) for a Council Regulation.

5 ESM replaced the temporary fund, the European Financial Stability Facility (EFSF).

6 European Council (2011): The Euro Plus Pact – Stronger Economic Policy Coordination for Competitiveness and Convergence. Annex 1 on the Conclusions of the European Council, 24–25 March 2011.

joined by the 23 EU countries. It focused on fostering competitiveness and employment, and on contributing to the further sustainability of public finances and financial stability. Although still in existence, the role of the Euro Plus Pact has diminished as many of the topics are now included either in the EU legislation (e.g. competitiveness in the MIB) or in the TSCG (e.g. fiscal rules).

In December 2011, the European Council agreed on the Treaty on Stability, Coordination and Governance. The TSCG is an intergovernmental treaty between 25 EU countries.<sup>7</sup> Only the UK and the Czech Republic decided to opt out of the TSCG. The Treaty consists of three major titles: III Fiscal compact, IV Economic policy and coordination, and VI Governance of the euro area. As a rule, it will apply to a non-euro country on the day it joins the euro, unless it declares itself to be fully or partially bound by Titles III and IV. Therefore, the Treaty is fully binding only for the euro members. The granting of financial assistance under the ESM is conditional on ratification of the TSCG.

The purpose of the TSCG is to strengthen the economic pillar of the EMU. The most important parts of the contract are the fiscal compact, which effectively obliges member states to add the Medium-Term Objectives (MTOs) to the stability or convergence programmes, as well as an automatic correction mechanism to their national legislation should a serious deviation from the MTO occur. The TSCG also reinforces the agreement between the euro countries to use a stricter voting rule when deciding whether a euro country is breaching the excessive deficit criterion.

The TSCG entered into force on 1 January 2013 and the aim is to incorporate the substance of the Treaty into EU legislation within five years.

### Upgrading to EMU 2.0 and EU 2.0?

Since December 2012 two reports have set out the framework for future reforms of the EMU: the “Towards a Genuine EMU” report by European

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7 European Council (2011) Treaty on Stability, Coordination and Governance of the Economic and Monetary Union. Finalized version 31 January 2011.

Council President Herman Van Rompuy<sup>8</sup> and “A Blueprint for a Deep and Genuine EMU” by Commission President José Manuel Barroso.<sup>9</sup> These proposals, which explicate the decisions that have been taken and set out a mid-term and longer-term vision for the EU, can be assessed from several angles. One concerns how deep the integration needs to be in order to ensure that the economic framework of the EMU will be robust enough. Another angle concerns the political will of the member states. A third aspect relates to what can be implemented within the current Treaty and which proposals require a Treaty change.

At the same time, since autumn 2012, the current crisis has started to show signs of easing. When the market pressure eases, governments have often been tempted to halt fiscal consolidation and structural policies. The same is likely to hold true in the future.

Thus, the reform of the EMU is likely to be halted if the pressure to reform weakens. In this case, a possible (mid-term) solution could entail updating the current institutional set-up with the changes already in the pipeline. It would then consist of the stronger framework for fiscal governance (six-pack, two-pack, TSCG), the completion of the single supervisory mechanism, and the resolution authority complemented by the harmonization of the deposit insurance scheme. The ESM would function as a crisis fund for sovereigns and as a bail-out fund for the banking system. These steps are already substantial and it may be prudent to assess their full impact before rushing ahead. A third and more straightforward justification is that these steps can be taken without a Treaty change.

This set-up could be dubbed EMU 2.0. Its spirit would still be close to the original Maastricht EMU and, as a general rule, member countries would still be responsible for their own economies, with the exception of support during a time of crisis. The tightened and extended governance and the partial

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8 Van Rompuy, H. (in close collaboration with J.M. Barroso, J-C Juncker and M. Draghi) (2012): *Towards a Genuine Economic and Monetary Union*, 5 December 2012.

9 European Commission (2012): *A Blueprint for a Deep and Genuine Economic and Monetary Union. Launching a European Debate*.

removal of banking and sovereign risks should help to address the worst flaws identified in EMU 1.0.

EMU 2.0 would imply increasing differentiation within the EU, but it would alter neither the common goal principle nor the current institutional framework. It would be open to all EU members to join, yet the criteria would likely be tighter and reflect the reforms of the EMU. As euro membership would come with stricter conditionality and tighter integration, it could raise the barrier to entry of the EMU. As a result, differentiation might turn out to be a more permanent feature of the EMU.

While EMU 2.0 would not alter the EU's institutional set-up per se, the deepening integration among the euro countries would raise questions regarding the relationship and position of the quasi-institutionalized euro group vis-à-vis other member states and joint EU institutions. As long as the decision-making of the Eurogroup remains largely intergovernmental in character, the democratic legitimacy can be provided by the national parliaments of the Eurogroup countries. Should the need for a substantial new euro area-specific legislation arise, the thorny question of voting in the Council and the European Parliament would likely emerge.

If the Treaty were opened and renegotiated, it would probably lead to attempts to take bigger steps. Changing the Treaty is such a complex and long drawn-out process that if the political will existed, it might be worthwhile trying to make all the considered changes to facilitate a "quantum leap" in the economic (and political) integration. These additional steps could include a true banking union with a common deposit insurance scheme and a union-level fiscal authority. The fiscal authority would be in charge of the coordination of structural and stabilization policies. It would have its own income (e.g. part of VAT could be earmarked for the fiscal authority) and have the right to issue common debt.

The spirit of the Union would be different due to the deepened political integration, resulting in what could be termed EU 2.0. However, there would be a wide array of options even within this set-up. One question concerns the extent of the fiscal authority. The fiscal authority drafted in the van Rompuy report would not necessarily be broad as it is intended to stabilize idiosyncratic shocks and to

be cost neutral across the economic cycle. In reality, both of these assumptions are questionable, however. Historically, economic downturns and crises have been relatively synchronized, affecting more than just a few countries. Should this be the case in the future as well, the common fiscal authority needs to be more far-reaching if the rationale is to have the capability to stabilize economic cycles. In order to be credible, this would change the relative size of the member states considerably, as well as central authority budgets and the nature of the Union at large.

Thus, deepening political integration would be an important facet of EU 2.0. For instance, a far-reaching common fiscal authority needs to be legitimized by improved democratic frameworks. A common macro-economic decision-making facility in allocating common funds would also wield political rather than technical authority and legitimacy. The same would apply to a full-fledged banking union, should the system fail to avert a systemic crisis, and budget funding be deemed necessary as a last resort to overcome the crisis.

If the elements of deepening integration envisaged in the tabled proposals affected only the euro countries, the EU's institutional framework would likely undergo dramatic changes. For instance, the European Parliament, Council and Commission could be divided into two parts, with one part overseeing the core (euro) countries, and the other the non-euro countries. Thus, the current situation, where the decisions that are financed by the euro countries are de facto made by the Eurogroup, would overhaul the current system. As a result, the difference between a euro and a non-euro EU country would clearly be more significant than is currently the case.

## Conclusion

Has the crisis served to reinforce the two-layer economic integration structure in the EU? The answer is a resounding yes. Many of the new rules and structures created during the crisis have focused on finding a solution to the euro crisis and are thus euro area-specific. The crisis management tool, the ESM, is only open to the euro countries. In addition, much of the new economic coordination legislation (parts of the six-pack, and the two-pack) is based on Article 136 of the Lisbon Treaty, which allows

euro countries to agree on stricter rules regarding economic governance. For example, the two-pack applies to the euro countries only. Furthermore, the financial sanctions that are being determined in line with the tighter voting rules only apply to the euro area.

However, as regards the legislation agreed so far, there is little evidence of dramatic change compared to the Maastricht EMU. All the changes are still in line with the basic idea that all EU countries will join the euro when they are ready and able. The potential costs related to ESM capitalization, for example, are probably making membership appear less attractive in the short term, but as the Lithuanian example shows, there are still countries wishing to join the EMU, even during the crisis. The changes agreed so far have not changed the Maastricht spirit of the EMU; they are merely serving to upgrade it to EMU 2.0.

One of the key questions in the near future is likely to concern the contours of the euro area-specific decision-making, and its relationship to the EU as a whole, and its institutions and procedures. Even if the new reforms aimed at a genuine and stable EMU remain open for all EU members to join, current trends suggest that non-euro members will be sidelined where much of the euro area governance is concerned until such time as they join. Even if the Eurogroup remains 'formally informal', it has managed to transform itself into a de facto institution within the EU, and its role and weight is likely to increase rather than decrease.

The Finnish Institute of International Affairs  
tel. +358 9 432 7000  
fax. +358 9 432 7799  
www.fiia.fi

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