



EUROPEAN

POLICYBRIEF

EMU REFORMS: AT THE MERCY OF ECONOMIC CYCLE?

EMU CHOICES

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The systematic analysis of member states' preferences indicates that gradualist EMU reforms remain the only politically feasible scenario. Deeply divided policy preferences, single-dimensional nature of the policy conflict and legacies of crisis decision-making prevent faster progress. Our research also indicates that financial sector exposure was the best predictor of national preferences, which suggests that de-risking of national finances can provide basis for preference convergence and thus for agreements on further EMU reforms.

INTRODUCTION

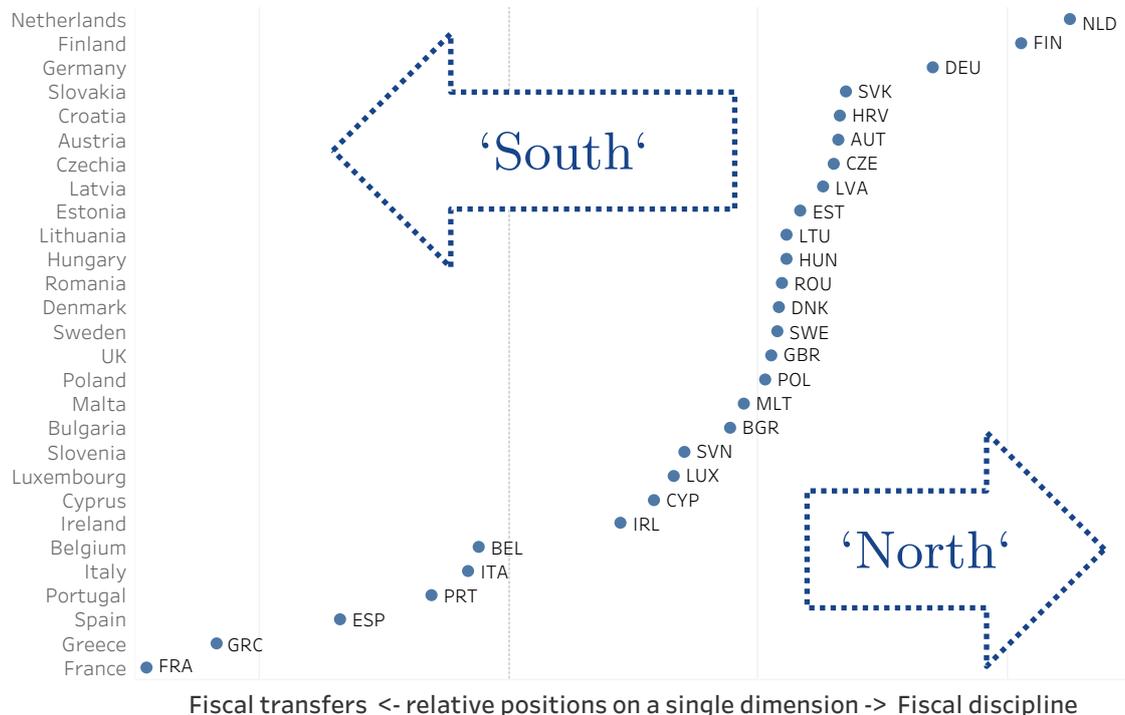
The systematic empirical analysis of member state policy preferences undertaken by the EMU Choices project, confirms some common wisdom, provides insights into potential openings for further EMU reforms and dispels unhelpful myths. Our findings support policy recommendations based on the current gradualist approach to reforms, whereby risk reduction in national banking sector goes hand-in-hand with a search for compromise reform designs. Since gradualist reform scenario relies on preference convergence as a mechanism to deliver agreements, it also implies much longer time horizons for the completion of the EMU architecture. However, the long-term reform outlook leaves the Eurozone exposed to a risk of facing another crisis without adequate stabilization mechanisms. Therefore, we also recommend the development of a separate set of reform proposals that could be adopted under the crisis pressures and that are likely to differ from the gradualist reform designs. Last, but not least, the EU should also explore innovative economic ideas that might adapt to political and legal constraints better than existing proposals.

EVIDENCE AND ANALYSIS

The empirical analysis of Eurozone politics highlights several important constraints on EMU reforms as well as factors that provide a supportive basis for further changes. The deep divide of policy preferences, single-dimensionality of the policy conflict and centralized formation of preferences help to explain the current reform stalemate. At the same time, the strong influence of financial sector exposure on member state preferences as well as the demonstrated capacity to negotiate balanced legislative compromises are conducive for gradual EMU reforms based on preference convergence.

Lehner and Wasserfallen (2019) analyze the novel dataset of member state positions on 40 contested aspects of EMU reforms and confirm the common wisdom about the ‘North-South’ divide among EU members (Figure 1). Aggregated data on the Six-Pack, Two-Pack, Fiscal Compact, European Financial Stability Facility, European Stability Mechanism, assistance to Greece, and the Banking Union reveal that member states’ positions are divided - one pole of the reform debate was occupied by countries such as France, Greece or Spain, while the Netherlands, Finland, and Germany most strongly represented the other.

Figure 1: Ideal point estimates of member state positions on 40 contested aspects of Eurozone reforms in 2010 to 2015



However, Lehner and Wasserfallen (2019) also point out that the policy conflict structure is single-dimensional, which is an insight that can be obtained only through systematic empirical analysis. Multi-dimensional conflicts characterize most EU policy domains as substantive policy interests are combined with the left-right ideological orientation of governments or their general preference for more or less integration. In contrast, none of these considerations mattered in

recent EMU reform debates as member states' positions were ordered along a single dimension, pitting the 'Southerners' preferring fiscal transfers against the opposition of 'Northerners' supporting fiscal discipline.

The absence of additional dimensions effectively precludes a formulation of package deals, whereby member governments are prepared to make concessions on EMU reforms as long as they are aligned with their political orientation or in exchange for benefits in some other policy domain. The single-dimensional nature of the conflict requires governments to negotiate compromises on the given policy issue without recourse to side-payments related to other policies.

Related research indicates that the formation of national policy positions of member states was strongly influenced by governments and EU institutions, which were more influential than other political or business actors. Kudrna et al. (2019) analyzed data based on 141 expert interviews carried out in all EU member states in 2016 and 2017 that confirm this executive bias in preference formation (Figure 2). While in some EU countries only governmental actors - defined as the office of the head of government, key ministries of finance/economy and foreign/European affairs as well as the central bank – influenced national position (Figure 2, bottom panel), in most there was some involvement of parliamentary parties, media and public opinion. Only in member states with established practices of economic policy coordination and in those most impacted by the crisis, the preferences were also influenced by business actors (Figure 2, top panel). The EU institutions, including the Commission, Eurogroup or ECB, are the second most influential group after the government in nearly all EU countries.

Figure 2: The weighted average of influence scores of actors influencing national positions



The dominant role of executive actors in preference formation eased the adoption of EMU reforms during the crisis. Governments presented reform proposals as economic necessities pre-

negotiated on the EU level, which often limited the voice of other national stakeholders. At the same time, it paved the way for a populist backlash against EMU reforms in many EU countries.

Overall, deep divisions between the two coalitions, the single-dimensionality of the policy conflict and political backlash against technocratic policy-making impose severe constraints on the political feasibility of EMU reform proposals. In this context, the absence of any major reform agreement since 2014 confirms the low expectations derived from the systematic analysis of Eurozone politics. However, the structural roots of policy preferences and ability to reach balanced legislative compromises offer some prospect for gradual reforms.

The best predictor of domestic preferences was the exposure of the national financial sector. In an analysis by Tarlea et al. (2019: 39) it trumped domestic political factors, such as the ideology of governing parties, the share of Eurosceptics in the parliament or prevailing public opinion on European integration. Throughout the crisis, governments acted as risk minimizers as they were more likely to support EMU reforms when their national financial sectors were relatively large in relation to the overall size of the economy and more exposed to other Eurozone economies through financial and payment links. This induced member states from the 'Northern' coalition to support reforms that pool risks across Eurozone countries and imply risk-sharing, including temporary fiscal transfers, from the more to the less stable economies.

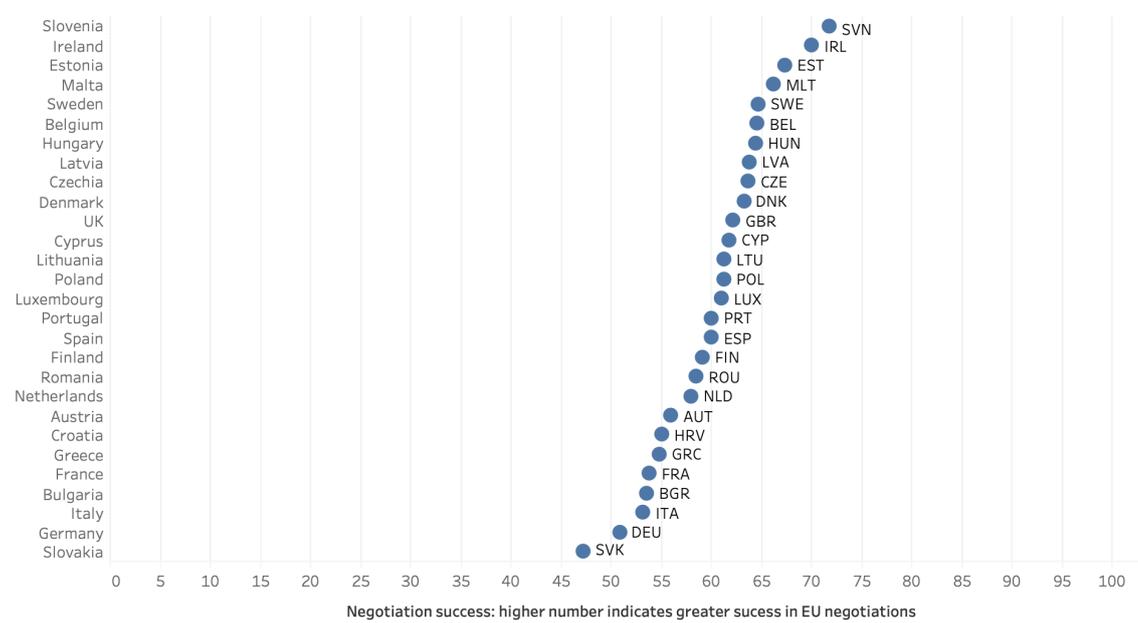
There is an overwhelming consensus that the EMU architecture needs to be completed by additional reforms introducing new tools such as common deposit insurance, fiscal backstop for bank resolution as well as some form of European safe asset and macroeconomic stabilization (via fiscal capacity or borrowing through European Investment Protection Scheme, European Unemployment Scheme or some form of rainy-day fund). However, as the crisis subsided the logic of minimizing risks to the national financial sector induces 'Northern' governments to postpone these reforms, as they strive to prevent the (mis)use of any new stability tool to cover legacy losses. Yet, if legacy losses and risks in EU economies are reduced, the opposition to further reforms may subside.

In short, because member state preferences are ultimately rooted in structural economic factors, change in these factors can facilitate the convergence of preferences as the 'Northern' countries abandon the short-term focus on legacy risks in favor of a long-term focus on the common interest in Eurozone stability and resilience.

A joint Franco-German proposal could also speed up the reform process. These two countries have traditionally served as the 'engine of integration' and controlled the reform agenda throughout the crisis (Degner and Leuffen 2009). Moreover, their joint proposals have a good chance for broader acceptance, because the two countries occupy opposite ends of policy preferences (see Figure 1).

However, the influence of the large member states on agenda setting does not imply that they can force their will on all other EU members. In particular, the myth of German dominance of the EMU reform process is not supported by systematic data analysis. Lundgren et al. (2019) document empirically that the average negotiation success – understood as whether or not a country gets what it wants in EU legislative bargaining – was evenly distributed across member states (Figure 3). Most member states were able to achieve some of their goals, but none got its way all the time. The relative symmetry of reform outcomes also indicates the capacity of the EU system to deliver balanced compromises, if preferences converge sufficiently for the reform proposal to reach legislative negotiations.

Figure 3: Average negotiation success of member states



POLICY IMPLICATIONS AND RECOMMENDATIONS

The systematic analysis of the key characteristics of Eurozone politics leads us to four policy recommendations that can enhance the political feasibility of EMU reforms. While the first two focus on the gradual reform scenario, the latter two address alternatives.

1. Support the convergence of preferences by reducing financial risks: The influence of the financial sector exposure on national preferences of member states provides the key building block for future reforms. While there is a strong consensus on the need to complete the EMU architecture by additional risk-sharing mechanisms, the opposition to further reforms is motivated by concerns about legacy losses and risks. The ‘Northern’ member states fear that new mechanisms for crisis prevention and stabilization could be used to pay for past losses in the ‘Southern’ banking sectors. De-risking banking sectors across the EU allays these concerns and paves the way towards the agreement on EMU reforms, especially those aimed at the completion of the banking union. In this context, the national schemes for bank restructuring that reduce non-performing assets can serve as a prerequisite for the convergence of preferences on the issue of

common deposit insurance and thus facilitate a compromise on the European Deposit Insurance Scheme.

2. Develop gradual EMU reform designs: The EMU reform agenda of deepening financial, economic, fiscal and political unions was outlined in numerous high-profile reports. Initial ambitions implied time horizons for completion of these unions by 2025, however - with the gradual preference convergence as the most likely reform-enabling mechanism - the timescale will be longer. Currently, the Commission strives to enhance the political feasibility of reform proposals by reducing the scope of risk-sharing, postponing deadlines, watering-down their most controversial provisions or resorting to largely symbolic changes in economic governance. While such changes increase the gap between initial ambitions and current proposals, they are consistent with the gradual reform scenario. The completion of the EMU architecture is likely to emerge from a cumulation of modest reforms enabled by preference convergence. Consequently, the Commission and member states should continue the search for politically feasible reform designs for the full range of proposal contained in Presidents' reports, while also discussing the potential for treaty change that would provide solid legal base and democratic legitimacy.

3. Be prepared for crisis-induced EMU reforms: The crucial assumption of the gradualist scenario is that the E(M)U will be able to avoid existential crisis for sufficiently long time to complete its reforms. While there is no reason to assume another global crisis in near future, it can never be excluded entirely. Therefore, the Commission should keep developing another set of reform designs for deepening the banking union and enhancing the macroeconomic stabilization mechanisms that could be adopted in crisis circumstances, when the existing stabilization mechanisms such as ESM and SRF could be overwhelmed. Such policy proposals are likely to differ from the gradualist reforms, because they might need to achieve major breakthroughs, if member states face the stark choice between completing of EMU or its catastrophic disintegration. Moreover, such emergency reforms need sound democratic legitimacy to gain broad political support. Thus, there needs to be an ongoing open debate with the European and national parliaments about alternatives to gradualism.

4. Support innovative economic thinking: The EMU Choices project aimed to provide more systematic understanding of Eurozone politics to assess the political feasibility of EMU reforms. We have taken the existing list of EMU reform proposals and looked at why and how some were or were not adopted. However, there is always a possibility that there are alternative economic proposals, that could improve the EMU architecture, while respecting the political and legal constraints extensively documented by our project. The unorthodox monetary policies of the ECB serve as a reminder that novel ideas can play a fundamental role in the EMU development. Hence, the Commission should always support research into innovative economic proposals, while at the same time assessing their impact on the institutional set-up to avoid legitimacy questions and difficult legal disputes before national and European courts.

This policy brief is based on the analysis of two datasets compiled by the EMU Choices research consortium and several original research articles listed below.

EMU Positions dataset contains coded positions on policy proposals that were negotiated during the Eurozone crisis of 2010 to 2015. It covers 47 contested policy issues related to the Six-Pack, Two-Pack, Fiscal Compact, European Financial Stability Facility, European Stability Mechanism, assistance to Greece, and the Banking Union as well as several forward-looking proposals from Presidents' reports. National positions were coded on the basis of document analysis of about 5000 secondary and primary sources, including official documents as well as the reporting by reputable media. The position score of each member states is coded within the unidimensional policy space delimited by the most extreme proposals on the given issue; the position implying the least integration is coded as 0, while the one implying most integration is coded as 100, with in-between proposal assigned corresponding scores between 0 and 100. The coding from the document analysis was validated by 29 interviews with experts involved in the respective negotiations on EU level. Further information on the EMU dataset is available from:

- *Wasserfallen, F., Leuffen, D., Kudrna, Z., & Degner, H. (2019). Analysing European Union decision-making during the Eurozone crisis with new data. European Union Politics, 20(1), 3–23.*

The analysis of Eurozone politics noted in this policy brief is derived from the following research articles:

- *Lehner, T., & Wasserfallen, F. (2019). Political conflict in the reform of the Eurozone. European Union Politics, 20(1), 45–64.* Several dimension-reduction methods show that the political contestation in the reform of the Eurozone is one-dimensional between advocates of fiscal transfer and discipline. Germany and France lead the two opposing groups. This conflict structure provides a setting conducive to the constant (re-)negotiation of compromises.
- *Târlea, S., Bailer, S., Degner, H., Dellmuth, L. M., Leuffen, D., Lundgren, M., Tallberg, J. and Wasserfallen, F. (2019). Explaining governmental preferences on Economic and Monetary Union Reform. European Union Politics, 20(1), 24–44.* This multilevel analysis of European Union member governments' preferences suggests that countries' financial sector exposure has significant explanatory power. Seeking to minimize the risk of costly bailouts, countries with highly exposed financial sectors were more likely to support solutions involving high degrees of European integration. In contrast, political factors had no systematic impact.
- *Lundgren, M., Bailer, S., Dellmuth, L. M., Tallberg, J., & Târlea, S. (2019). Bargaining success in the reform of the Eurozone. European Union Politics, 20(1), 65–88.* This article develops a theoretical argument about preferences and institutions as determinants of

bargaining success and contrast this argument with an alternative account privileging states' power resources. Empirical findings point out that contrary to a conventional narrative of German dominance, the negotiations produced no clear winners and losers. While power resources were of limited importance, holding preferences that were centrist or close to the Commission favored bargaining success.

- *Degner, H., & Leuffen, D. (2019). Franco-German cooperation and the rescuing of the Eurozone. European Union Politics, 20(1), 89–108.* This article documents the Franco-German influence exercised via the elimination of issues from the negotiation agenda; the identification of compromise solutions or the provision of compensations; and the power-based imposition of joint agreements on other member states.

EMU Formation dataset is based on 141 semi-structured expert interviews in each EU member state. The dataset includes position and influence scores for 22 internal and external actors, grouped into six broad categories (see x-axis in Figure 2). For each actor the dataset provides position and influence scores on four contested policy issues that are representative of the single underlying dimension of political conflict on EMU reforms. The position score of each actor on given issue is coded within the unidimensional policy space delimited by the most extreme proposals on the given issue; the position implying the least integration is coded as 0, while the one implying most integration is coded as 100. Actor's influence is also coded within 0 to 100 policy space, but in this case the score indicates the influence exerted on the formation of national positions. The scores were assigned by interviewed experts, who were selected on the basis of their personal involvement in the relevant decision-making process, mostly from ministries, but also from national parliaments, permanent representations, media or academia. Since we have collected between 3 and 8 interviews in each member state, position and influence scores were aggregated by weighted averaging, with quality ratings assigned to each interview used as weights. To avoid potential bias from idiosyncratic interviews, only scores for actors that were indicated as influential by at least two interviewees were included. Further information on the EMU dataset as well as the analysis underpinning our observations on the formation process is available from:

- *Kudrna, Z., Bailer, S., Tarlea, S. And Wasserfallen, F. (2019). Three Worlds of Preference Formation in European Union Politics: Evidence from New Data on Eurozone Reforms. EMU Choices Working Paper.*

PROJECT IDENTITY

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