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## Document de travail

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# **If it's Broken, Don't Fix it: The Government of the Euro area in the EU "Reform Treaty"**

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If it's Broken, Don't Fix it:  
The Government of the Euro area in the EU "Reform Treaty"

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**Abstract**

The government of the Euro area – the institutions, objectives and instruments of the regional area pooling together the monetary sovereignty of the 13 EU member states that share the euro – was obviously the blind spot in the otherwise animated negotiations of the sessions of the European Convention, and then of the Intergovernmental Conference in 2004. What seemed then a missed opportunity now looks like a major collective failure. This paper examines the reforms of the “economic governance” of the euro area proposed by the “Treaty amending the Treaty on European Union and the Treaty establishing the European Community” (also called the “Reform Treaty”) and concludes that they do not match the challenges faced collectively by the euro area economies.

The government of the Euro area – the institutions, objectives and instruments of the regional area pooling together the monetary sovereignty of the 13 EU member states that share the Euro – was obviously the blind spot in the otherwise animated negotiations of the sessions of the European Convention, and then of the Intergovernmental Conference in 2004. What seemed then a missed opportunity now looks like a major collective failure.

Euro area member states in 2007 dangerously diverge in terms of inflation, growth and current accounts; economic policy choices are made separately, threatening European cohesion and monetary union in its very principle; tax and social competition is becoming the norm between neighbors and partners; an exchange rate policy able to domesticate an out-of-control Euro is still missing; the short-lived European recovery seems to already cool down in a context of global uncertainty. Who can now doubt that an open and thorough debate on the reform of the functioning of the core of European economic integration was badly needed, and still is?

True, new provisions regarding the euro area were inscribed in the friable marble of the “European Constitution” (“The Treaty establishing a Constitution for Europe”). The text of the “Draft Treaty amending the Treaty on European Union and the Treaty establishing the European Community” in Lisbon on October 18<sup>th</sup>, called “Draft Reform Treaty” (“Reform Treaty” hereafter), reminds us that some “reforms” of the euro area have indeed been decided when the “European Constitution” was signed. Since the 2007 Intergovernmental Conference (IGC) mandate quotes “the improvements to the governance of the Euro” among “the innovations...agreed in the 2004 IGC” that “will be inserted into the Treaty”, one has to review the changes in question and assess if they match the challenges faced collectively by euro area economies. The short answer: no, alas.

### *Will the ECB be more independent?*

One can only regret that the European symbols put forward in Article I-8 of the “European Constitution” have disappeared from the “Reform Treaty”. The “euro” finally replaces the “ECU” as the official European currency, and it is also mentioned in Article 3 of the new text, but this downgrading takes some democratic value away from the euro.

This feeling becomes stronger when the reader explores the new provisions regarding the European Central Bank (ECB). To start with, and this is not a minor issue, the ECB gains financial independence in the new Treaty<sup>1</sup>, as stated in the new Article 245a:

The European Central Bank shall have legal personality. It alone may authorise the issue of the euro. It shall be independent in the exercise of its powers and in the management of its finances. Union institutions, bodies, offices and agencies and the governments of the Member States shall respect that independence.

This new provision had been asked by the ECB itself in its opinion of 19 September 2003 (ECB, 2003). As a matter of fact, the new section 4a is largely inspired from the ECB demands. The ECB

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<sup>1</sup> Presidency of the IGC (2007a) and (2007b).

thus logically expresses its general satisfaction with the new text in its Opinion of 5 July 2007<sup>2</sup>. Yet, on second thought, one point has become problematic for the ECB, which even decided to publicly warn the Portuguese Presidency about it.

There is no question that the ECB will be even more independent after the Reform Treaty is being implemented than before (with the consolidated version of the Nice Treaty). The text makes the ECB into an institution of the EU (Article 9), which does not change anything to its statutes, mandate, objectives or instruments but strengthens its original institutional position, since it is the only EU institution with the legal personality. Yet, the ECB expressed its opposition as soon as 2003<sup>3</sup> to this integration into the EU framework and asked for a specific treatment:

Because of its specific institutional features, the ECB needs to be differentiated from the ‘Union’s institutions’ and this justifies the fact that Art. I-18 does not list the ECB.

To increase the clarity, consistency and soundness of its institutional status, if not for purely editorial reasons, the ECB would like to recommend that the heading of Title IV be changed to ‘The Institutional Framework of the Union’.

The wording of the “European constitution” actually sustained the ECB claim, categorizing the Bank among the “other Union’s institutions”. By reintroducing the ECB among the Union’s institutions, the Reform Treaty triggered a stiff, if delayed, reaction. In a letter to Manuel Lobo Antunes (President of the Council of the European Union) on August 2 2007, Jean-Claude Trichet, President of the ECB, writes that while “the ECB considers that...the changes to be introduced to the text of the current Treaties are limited to and comprise all the innovations agreed at the 2004 ICG...this does not appear to be the case on the question of the institutional status of the ECB”. The President adds that the ECB would therefore like that “the reference to the ECB...should be moved...under the rubric, “The other institutions are”” and that the rubric “The Union’s institutions” should be replaced by “The Union’s institutional framework”.

The ECB did not win its case in Lisbon since its legal interpretation of the new text as limiting in any way its independence did not convince the overwhelming majority of EU member states. But it speaks volumes on the ECB conception of democracy: it does not want to be part of the European political system.

As regards the ECB’s mandate, “price stability” becomes, here again following the Bank 2003 opinion, an objective of the Union. Article 3 of the “Reform Treaty” states that the Union:

...shall work for the sustainable development of Europe based on balanced economic growth *and price stability*, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

In the same vein, Article 3 of the new Title I (“Categories and areas of Union competence”) explicitly ranks monetary policy as an area of exclusive competence for the euro area countries:

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<sup>2</sup> ECB (2007).

<sup>3</sup> ECB (2003).

1. The Union shall have exclusive competence in the following areas:
  - (a) customs union;
  - (b) the establishing of the competition rules necessary for the functioning of the internal market;
  - (c) monetary policy for the Member States whose currency is the euro;
  - (d) the conservation of marine biological resources under the common fisheries policy;
  - (e) common commercial policy.

One of the many stakes of this wording is the exact scope of this competence, and in particular the problematic sharing of the exchange rate policy between the ECB and the Council.

### *Will Europe finally have an exchange rate policy?*

The Euro so far is not only a currency without a State, but a currency without sovereignty. It is not governed on the global scene because it has been *de facto* put under the sway of an independent authority (the ECB) whose conviction is that the euro area should not have an exchange rate policy. This position was clearly expressed at the very beginning of the ECB by its first President the late Wim Duisenberg:

On the question of exchange rates and target zones, I would like to state clearly that, in its monetary strategy, the ESCB does not have an exchange rate target. Nor do the United States and Japan. An exchange rate target for an area as large and relatively closed as that of the euro area could easily conflict with the maintenance of price stability and could, therefore, not be sustainable. According to our monetary policy strategy, the exchange rate of the euro will thus be an outcome, rather than the objective, both of the economic, monetary and other policies pursued in the euro area, and of cyclical developments in the euro area and abroad. It will be monitored as one of the indicators of monetary policy and as a source of potential changes in the price level in the euro area<sup>4</sup>.

While the consequences of the chaotic European monetary system were logically negative for European countries, one could reasonably hope that the creation of the single currency would give the Euro zone economy a true monetary sovereignty. Because of the ECB beliefs and the national governments passivity, it has not been the case.

The priority has clearly been given since 1999 to price stability over exchange rate stability. As a result, since 1999, the Euro has been “strong” when the economy was “weak” and “weak” when the economy was “strong”. In other words, the Euro exchange rate has destabilized the Euro area economy instead of contributing to stabilize it. The activism of the European Central Bank on the Forex market has been asymmetric: it intervened when the Euro depreciated (threatening price stability), but not since it has appreciated.

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<sup>4</sup> “The International Role of the Euro and the ESCB’s Monetary Policy”, 20 November 1998, <http://www.ecb.int/press/key/date/1998/html/sp981120.en.html>

At the global level, the Euro area is thus only an involuntary player in the international monetary system, through the risk derivation circuit played by the Euro with respect to the dollar. Hence, the Euro can be said to serve as the adjustment variable to global imbalances. Without an exchange rate policy of the Euro zone, movements of the exchange rate of the Euro simply reflect the exchange rate policies of the rest of the world.

On the contrary, one can make the argument that the Euro zone economically needs an exchange rate policy and is legally entitled to it. European law, on this point ambiguously unambiguous, gives the shared responsibility of the exchange rate policy to the ECB and the Council. The ambiguity runs both ways: the Council can formulate general orientations for the exchange rate policy but must respect the ECB lexicographic order (price stability is first, then comes the rest, Article 105 of the European Union Treaty) and the ECB, submitted to this order, must support those orientations when they are formulated (Article 111).

#### Article 111

1. By way of derogation from Article 300, the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 for determining the arrangements, conclude formal agreements on an exchange-rate system for the ecu in relation to non-Community currencies. The Council may, acting by a qualified majority on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the ecu within the exchange-rate system. The President of the Council shall inform the European Parliament of the adoption, adjustment or abandonment of the ecu central rates.
2. In the absence of an exchange-rate system in relation to one or more non-Community currencies as referred to in paragraph 1, the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.

#### Article 105

1. The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4.
2. The basic tasks to be carried out through the ESCB shall be:
  - to define and implement the monetary policy of the Community,
  - to conduct foreign-exchange operations consistent with the provisions of Article 111,

- to hold and manage the official foreign reserves of the Member States,
- to promote the smooth operation of payment systems.

More precisely, since, as the ECB itself puts it, the “ultimate responsibility” for the exchange rate policy lies with the member states, a distinction must be made between independence of means (also called “economic independence”) and of objectives (also called “political independence”). The ECB appears to be independent in terms of the means chosen to achieve the general objective set by the Council. But these objectives have to be discussed between the Council and the ECB. And these objectives and that of price stability have to be compatible. The exchange rate policy is thus (although somewhat tortuously) unambiguously legally a shared competence between the Council and the ECB.

Instead of conforming to this institutional framework, the Euro area member states have opted for the bizarre creation of the Euro group, the informal gathering of euro area economic and finance ministers, which has been created in 1997 with no legal basis to “dialogue” with the ECB (see *infra*).

The reform Treaty does nothing to pull the European exchange rate policy out of ambiguity and inertia. Consequently, the Euro will probably continue to be submitted to the objective of price stability, in a context where the dollar, the yen and the yuan all have good reasons to continue to depreciate on the exchange rate markets against the European currency. The “informal” recognition of the Euro group (cf. *infra*) and the creation of the “High Representative of the Union for Foreign Affairs and Security Policy” in the Reform Treaty will not change this state of affairs. The euro area has to rely on other macroeconomic instrument than the exchange rate.

### *Will the policy mix be more efficient?*

So far, the only provisions aimed at coordinating macroeconomic policies in the euro area are EU wide instruments, namely the “Broad economic policy guidelines” (BEPG) and the “Stability and growth Pact” (partly reformed in 2005). A case can be made that these rules, submitted to the price stability objective of the ECB, work against macroeconomic reactivity and a strong and sustained economic growth, but yet without insuring the degree of monetary stability or public finance sustainability that justify them<sup>5</sup>.

Indeed, the policy mix of the euro area consists in juxtaposing an excessively restrictive (or at least insufficiently accommodative) monetary policy, which has the regrettable tendency to shorten recoveries and prolong downturns, and national fiscal policies that are aggregately excessively expansionist, especially in recoveries (see Laurent and Le Cacheux, 2006). A better combination and coordination of both instruments is to be sought and found. The collective determination of fiscal and tax policies in order to avoid opportunistic national policies and the development of a substantial dialogue with the ECB is for instance likely to allow the euro area to benefit from a stronger growth, sounder public finance and easier to reform social models. But, here again, the reform Treaty is mute.

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<sup>5</sup> For a detailed argumentation on this point, see Creel, Laurent and Le Cacheux, 2007.



The punitive facet of the European coordination is the only one to be strengthened: the European Commission will now be able to directly warn a country that would not respect the BEPG, without having to wait for the Council approval. If the Council decides to address a recommendation to a country, the country will no longer be able to participate in the vote. The “excessive deficit” procedure of the SGP will also be strengthened: the Commission will now be able to bypass the Council to send a warning to a country. Finally, the Council will determine if a public deficit is excessive and if the sanction procedure is to be activated with a majority vote of countries (representing at least 65% of the euro area population), excluding the country subject to the procedure. The paradox of the Reform Treaty, which gives the euro area some much needed autonomy but only for discipline and not coordination, is further aggravated by new provisions.

*Will the euro area become more autonomous in the EU?*

4. The Union shall establish an economic and monetary union whose currency is the euro.

Article 3 of the Reform Treaty is, at the same time, good and bad news for the economic sovereignty of the euro area within the EU. On the one hand, the pivotal role of the Economic and Monetary Union (EMU) is recognized. But on the other hand, the euro area and the EU are institutionally imbricate by this wording when they should, on the contrary, be dissociated and not confused in the same institutional continuum (see Fitoussi, Laurent and Le Cacheux, 2007).

It is true that the “Reform Treaty”, which picks up the rare innovation of the European Constitution on the chapter of economic policy, gives for the first time more autonomy to euro area member states. But this autonomy serves coercion and not coordination. According to Article 114 of the new Chapter 3a, the euro area member states will have the ability to decide with a qualified majority to:

- (a) strengthen the coordination and surveillance of their budgetary discipline;
- (b) set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.

The only true improvement regards the emergence of a new formal framework to determine the representation of the euro area in international organizations:

1. In order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission, shall adopt a decision establishing common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences. The Council shall act after consulting the European Central Bank.
2. The Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation within the international financial institutions and conferences. The Council shall act after consulting the European Central Bank.

But whatever its shortcomings, one has to acknowledge that new Chapter 3a, because it marks for the first time the need of specific provisions and procedures for euro area member states, is the most important progress made by the “Reform Treaty” regarding the government of the euro area. The same can not be said of the new provisions that concern the Euro group.

### *Will the Euro group be institutionalized?*

The Euro group, the informal gathering of euro area economic and finance ministers, is a non-institution that has been created with no legal basis to “dialogue” with the ECB. This baroque setting was decided at the European Council meeting in Luxemburg on 12 and 13 December 1997, which conclusions mark a clear distinction between formal and informal coordination:

The defining position of the ECOFIN Council at the centre of the economic coordination and decision-making process affirms the unity and cohesion of the Community.

The Ministers of the States participating in the euro area may meet informally among themselves to discuss issues connected with their shared specific responsibilities for the single currency. The Commission, and the European Central Bank when appropriate, will be invited to take part in the meetings

Article 115 of Chapter 3a of the “Reform Treaty” mentions the Euro group and states that:

Arrangements for meetings between ministers of those Member States whose currency is the euro are laid down by the Protocol on the Euro Group.

But these meetings clearly stay “informal”, the Council remaining the place where decisions are effectively taken. It is true that Article 115 and the Protocol n°3 recognize the existence of the Euro group for the first time ever in a European Treaty. What is more, the Protocol explicitly mentions the need to go further in the coordination of economic policies in the euro area, stressing the necessity:

...to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within the euro area,

...the need to lay down special provisions for enhanced dialogue between the Member States whose currency is the euro...

But Article 1 of the Protocol reminds the reader that the role of the Euro group is and will remain informal:

The Ministers of the Member States whose currency is the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency...

Article 2 of the Protocol simply states that:

The Ministers of the Member States whose currency is the euro shall elect a president for two and a half years, by a majority of those Member States.

Nowhere in the “Reform Treaty” is it indicated how the Euro group can find its place between the ECB, the Council and the Commission in the definition of the economic policies of the euro area. The example of the 2006 most publicized spat between the “two Jean-Claude”, the ECB President, Jean-Claude Trichet, and the Euro group President, Jean-Claude Juncker, has shown that the legal coordination that ought to take place according to the Treaties does not exist in reality because the ECB is simply much more powerful than the Euro group. The dialogue between the Euro group and the ECB on the exchange rate thus remains virtual, a point Jean-Claude Trichet has been very clear about:

I have said often enough that I am Mr Euro. There is no doubt: we issue the currency and I sign the banknotes. My signature is on the notes...In my understanding, the relationship that the ECB has with the executive branches, in line with the provisions of the Maastricht Treaty, is probably the best organized at the global level...Of course, in the European tradition and in the Maastricht Treaty, this is accompanied by what I would call the inflexible independence of the monetary authority, which is in the Treaty and which forms the basis of our credibility.<sup>6</sup>

The institutional minority of the Euro group is even reinforced by the creation in Article 112 of the “Reform Treaty” of an “Economic and financial Committee” in lieu of the “Monetary Committee with advisory status” created by the “European Constitution”. This Committee is to gather, like the Euro group, member states, the Commission and the ECB to promote, just like the Euro group, economic policies coordination.

### *Will competition be a means or an objective of the EU?*

The final reform regarding the euro area is not macroeconomic but microeconomic and regards the EU as a whole. The French government has asked and obtained at the June 2007 EU summit that competition no longer be an objective of European economic policies. Article 3 now merely states:

3. The Union shall establish an internal market.

This reform, apparently innocuous, could be of great importance if it were to signal a shift in the conception of economic policy in the EU. One can indeed argue that competition is no longer an objective but a means of economic policy. Actually, intermediary and final objectives of economic policy tend to be confused in the EU, “competition” and “price stability” being sought at the detriment of growth and full employment (see Fitoussi, 2002). But this interpretation of the “Reform Treaty” is probably too optimistic.

The British government has actually obtained that a new Protocol n°6 be added to the “Reform Treaty”, reducing the significance of the shift of competition from objective to means.

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<sup>6</sup> Press conference, 8 June 2006.

...the internal market as set out in Article 3 of the Treaty on European Union includes a system ensuring that competition is not distorted...

This amendment returns very close to the abandoned wording of Article I-3 of the “European constitution”:

2. The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, and an internal market where competition is free and undistorted.

Overall, the “Reform Treaty” amounts to a conservative reform of the government of the euro area, in the double meaning implied by the term. It will not change the current architecture of the economic policy institutions of the euro area and thus not remedy its failures. But it also reasserts the restrictive bias of the present system: by reinforcing the independence of the ECB, including, by default, in the exchange rate policy domain; by strengthening fiscal discipline without allowing for a better coordination; finally, by failing to build the cohesive economic sovereignty needed to give a political consistency to the economically integrated euro area. Is a major crisis the only way to convince the euro area member states to govern their economy?

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**SECTION 4a**  
**THE EUROPEAN CENTRAL BANK**

Article 245a

1. The European Central Bank, together with the national central banks, shall constitute the European System of Central Banks. The European Central Bank, together with the national central banks of the Member States whose currency is the euro, which constitute the Eurosystem, shall conduct the monetary policy of the Union.
2. The European System of Central Banks shall be governed by the decision-making bodies of the European Central Bank. The primary objective of the European System of Central Banks shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter's objectives.
3. The European Central Bank shall have legal personality. It alone may authorise the issue of the euro. It shall be independent in the exercise of its powers and in the management of its finances. Union institutions, bodies, offices and agencies and the governments of the Member States shall respect that independence.
4. The European Central Bank shall adopt such measures as are necessary to carry out its tasks in accordance with Articles 105 to 111 and Article 115a, and with the conditions laid down in the Statute of the ESCB and of the ECB. In accordance with these same Articles, those Member States whose currency is not the euro, and their central banks, shall retain their powers in monetary matters.
5. Within the areas falling within its responsibilities, the European Central Bank shall be consulted on all proposed Union acts, and all proposals for regulation at national level, and may give an opinion.”

**CHAPTER 3a**  
**PROVISIONS SPECIFIC TO MEMBER STATES**  
**WHOSE CURRENCY IS THE EURO**

Article 114

1. In order to ensure the proper functioning of economic and monetary union, and in accordance with the relevant provisions of the Treaties, the Council shall, in accordance with the relevant procedure from among those referred to in Articles 99 and 104, with the exception of the procedure set out in Article 104(14), adopt measures specific to those Member States whose currency is the euro:

- (a) to strengthen the coordination and surveillance of their budgetary discipline;
- (b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.

2. For those measures set out in paragraph 1, only members of the Council representing Member States whose currency is the euro shall take part in the vote.  
A qualified majority of the said members shall be defined in accordance with Article 205(3)(a).

Article 115

Arrangements for meetings between ministers of those Member States whose currency is the euro are laid down by the Protocol on the Euro Group.

Article 115a

1. In order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission, shall adopt a decision establishing common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences. The Council shall act after consulting the European Central Bank.

2. The Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation within the international financial institutions and conferences. The Council shall act after consulting the European Central Bank.

3. For the measures referred to in paragraphs 1 and 2, only members of the Council representing Member States whose currency is the euro shall take part in the vote.  
A qualified majority of the said members shall be defined in accordance with Article 205(3)(a)."

## **PROTOCOL (No 3) ON THE EURO GROUP**

THE HIGH CONTRACTING PARTIES,

DESIRING to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within the euro area,

CONSCIOUS of the need to lay down special provisions for enhanced dialogue between the Member States whose currency is the euro, pending the euro becoming the currency of all Member States of the Union,

HAVE AGREED UPON the following provisions, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

### Article 1

The Ministers of the Member States whose currency is the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currency is the euro and of the Commission.

### Article 2

The Ministers of the Member States whose currency is the euro shall elect a president for two and a half years, by a majority of those Member States.



## **PROTOCOL (No 6) ON THE INTERNAL MARKET AND COMPETITION**

THE HIGH CONTRACTING PARTIES,

CONSIDERING that the internal market as set out in Article 3 of the Treaty on European Union includes a system ensuring that competition is not distorted,

HAVE AGREED that to that end, the Union shall, if necessary, take action under the provisions of the Treaties, including under Article 308 of the Treaty on the Functioning of the European Union. This Protocol shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union.