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Tal Sadeh [a]; Erik Jones [b]; Amy Verdun [c]
[a] Department of Political Science, Tel Aviv University, Tel Aviv, Israel
[b] SAIS Bologna Center, The Johns Hopkins University, Bologna, Italy
[c] Department of Political Science, University of Victoria, Victoria, BC, Canada

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Legitimacy and efficiency: Revitalizing EMU ahead of enlargement

***Tal Sadeh*[1]*, Erik Jones*[2]*, and Amy Verdun*[3]**

[1]*Department of Political Science, Tel Aviv University, P.O. Box 39040, Tel Aviv 69978, Israel*
[2]*SAIS Bologna Center, The Johns Hopkins University, via Belmeloro 11, 40126 Bologna, Italy*
[3]*Department of Political Science, University of Victoria, P.O. Box 3050, Victoria, BC, Canada V8W 3P5*

ABSTRACT

Eight years after the launch of its third stage, and on the brink of its expansion, the European Union's (EU) Economic and Monetary Union (EMU) has proven to be successful. However, EMU has also highlighted the diversity of its members economic performance, and their need to run larger public deficits than they initially committed to. This special issue attempts to find out what can be done to relieve the tensions in EMU. The source of EMU's difficulty seems to lie in its weak legitimacy, ambiguous gevernance, and asymmetric institutional design. The EU needs to improve its fiscal rules and streamline decision making in the European Central Bank without eroding legitimacy.

KEYWORDS

Efficiency; EMU; enlargement; EU; legitimacy.

Eight years after the launch of its third stage, the European Union's (EU) Economic and Monetary Union (EMU) has proven to be both successful and complicated. It has eliminated exchange rate instability across much of Europe, lowered interest rates, made comparing prices easier, in so doing facilitating trade, travel and tourism, and deepened the European financial area. Recently, economic growth has also been accelerating among its member states after years of near-stagnation, although some argue that this is merely a cyclical development. The differences between those inside versus those outside EMU are declining. Although in the earlier years the EU member states that chose to stay out of the euro area were growing faster than those in EMU, recently the performance of the 'ins' has closely

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approximated those of the 'outs' (Commission, 2006: 133). Furthermore, EMU is on the brink of expansion. In January 2007 Slovenia became the first transition economy to join the euro area, Cyprus and Malta are scheduled to join in January 2008, and in the coming years more new members are due to join.

Nevertheless, EMU has highlighted the diversity of its members' economic performance, in particular how member states deal with public spending and the ageing population and related costs. This diversity was reflected especially in the member states' need to run larger public deficits than EU member states committed to run in the Treaty Establishing the European Community. The political–economic backdrop in Europe over the past few years is not helpful either: social tensions in France, the 2005 rejection of the European Constitutional Treaty by French and Dutch voters, difficulties in completing the single market, and strong disagreements among member states in issues ranging from energy and security to agriculture and the EU budget. In addition, the enlargement of the euro area to the east if not to the north–west, is expected to exacerbate these challenges for EMU.

As new administrations set in office in France and the UK and as the Baltic countries prepare for the single currency, this special issue attempts to find out what can be done to relieve the tensions in EMU. The contributions below portray a troubled currency union though not one in crisis. The source of EMU's difficulty lies in its weak legitimacy, which complicates efforts to resolve ambiguities in its governance. EMU's asymmetric institutional design leaves the project's legitimacy vulnerable to fluctuations in the perceived advantages and disadvantages of the euro. The euro-zone's enlargement to the UK (and perhaps to Denmark and Sweden too) can only be expected under severe crisis there.

What to do? The EU needs to continue to improve upon the fiscal rules agreed on in the Maastricht Treaty. A properly reformed Stability and Growth Pact (SGP) must allow for politically achievable budgetary goals, which reward national political leaders for the difficult decisions that they are required to take. Efficiency in the decision making processes of the European Central Bank (ECB) is important but it must not come at the expense of legitimacy. Thus, equal voting rights must be maintained in its General Council – the body responsible for setting monetary policy of the ECB. Furthermore, some 'democratic override' must be built into EMU, allowing for effective external review of the ECB and of the finance ministers of participating countries (the Eurogroup), as well as potential sanctions for extreme cases of departing from the preferences of a broad set of societal interests.

In his article on *Enlargement and the International Role of the Euro* Benjamin Cohen asks how enlargement of the EU will affect prospects for the euro as an international currency. He has long argued that Europe's joint currency is fated to remain a distant second to America's greenback because of

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three structural factors: (1) relatively high transactions costs, due to inefficiencies in Europe's financial markets; (2) an anti-growth bias built into the institutions of EMU; and (3) ambiguities at the heart of the monetary union's governance structure. On top of these concerns progress in building a global role for the euro has been underwhelming to date also because of the well documented inertia that is inherent in all monetary behavior, arising from stickiness in currency preferences.

In this issue Cohen extends his earlier analysis, focusing in particular on the impact of enlargement on the governance structure of EMU. From the start, internationalization of the euro has been retarded by a lack of clarity about the delegation of monetary authority among governments and EU institutions. The addition of a diverse collection of new members, with significantly different interests and priorities, will exacerbate ambiguity at the expense of transparency and accountability and make the challenge of governance worse. In fact, enlargement will aggravate the negative impact of all three factors that constrain the euro's international role. Bringing accession countries into EMU will prolong the segmentation of Europe's financial markets, and delay any significant reduction of the cost of doing business in euros. By adding to inflationary and budgetary pressures, enlargement will reinforce the anti-growth bias built into the institutional structure of EMU.

Of course, as the euro area is enlarged its economic base broadens and its potential for network externalities increases. Nevertheless, Cohen argues that enlargement will diminish, not expand, the euro's attractiveness as a rival to the greenback. Furthermore, though unlikely, the possibility that EMU could founder under the weight of enlargement cannot be dismissed.

The greatest challenge for the functioning of EMU has so far come from its beleaguered fiscal regime. Ever since 1996 the SGP has sought to tighten the discipline among the member states so that they comply with the Maastricht Treaty criteria. However, by late 2003 the EU's regime of fiscal constraint verged on the brink of collapse. The reform of the SGP adopted in March 2005 by the Council of Ministers on Economic and Financial Affairs (ECOFIN) emphasized the role of cyclically adjusted deficit calculations, expanded the conditions under which the member states could deviate from the budgetary targets, but retained the SGP's target of 3 percent deficit level and 60 percent debt level (in proportion to GDP). These reforms did not prevent one-third of the original 15 member states from running deficits in excess of 3 percent of GDP in 2005, despite the upswing in the economic cycle.

The troubles of the SGP and the prospect of the Euro-zone's enlargement underscore the need for reforms that would resolve the anti-growth bias and the governance ambiguities that Benjamin Cohen foresaw. Two articles in this special issue deal with reforms in EMU, one with the SGP, the other with reform of the ECB.

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In their article on *Reforming Europe's Stability and Growth Pact: Lessons from the American Experience in Macrobudgeting* James Savage and Amy Verdun argue that the continued reliance on the SGP's targets explains the failure of member states to comply with the EU's macrobudgetary rules. A properly reformed SGP must allow for politically achievable budgetary goals, which reward national political leaders for the difficult decisions that they are required to take. National politicians must be able to claim credit for their actions.

Savage and Verdun explore the American experience since 1985 with three macrobudgetary laws aimed at promoting fiscal stability: Gramm–Rudman–Hollings, the Budget Enforcement Act, and Balanced Budget Act. Macrobudgetary rules that rely upon deficit criteria produce budgetary targets that are often beyond the control of political actors. Thus, after several futile years of trying to control their deficits with the first of these laws, the Americans changed the goal to controlling spending in the latter two. The authors offer the EU a number of lessons from US experience. These include substituting spending targets for deficit targets, creating politically realistic and administratively manageable fiscal sanctions rather than draconian measures, and applying nominal spending caps rather than using a GDP basis.

In addition to these challenges to fiscal policy in the Euro-zone, future enlargement of the single currency potentially threatens the efficiency of its monetary policy making. Especially, extending the principle of equal representation of National Central Banks (NCBs) on the ECB's Governing Council to the new member states might stifle its decision making. In his article on *Running an Enlarged Euro-zone; Reforming the European Central Bank: Efficiency, Legitimacy and National Economic Interest* David Howarth argues that the reform that the Governing Council adopted in December 2002 distorts the guiding principles of ECB decision making: equality ('one governor, one vote'), representativeness (all the Euro-zone is represented) and *ad personam* participation (each governor votes in an independent and personal capacity).

The reform eliminates equal voting rights. Instead it emphasizes member state macroeconomic interest in determining their bargaining power and prioritizes the size of national economies and financial markets over population size. This distortion reflects the interests of the largest member states in maintaining disproportionate representation in the Governing Council, as well as the preferences of mid-size member states (notably The Netherlands). The reform thus weakens the future representation of NCBs of Central and East European EU member states, in order to diminish a structural bias in favor of higher interest rates. In fact, Howarth shows that the pre-reform bargaining power of individual Governing Council members already reflects the size of their home economies, the interests of which they defend.

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The proposed reform contributes to the suspicion that the ECB is particularly preoccupied with the effect of its policy on the largest economies, despite the official requirement that it target Euro-zone wide inflation. Worse still, this damage to the principles of ECB decision making is not compensated for by improved efficiency in ECB decision making, because of opposition from the smaller member states, and legitimacy concerns, which ensure a large and 'decentralized' Governing Council.

Howarth's article pits efficiency against legitimacy in the process of reform. This dilemma arises, at least in part, from the gap between monetary integration and political integration in Europe, which gives rise to questions about the democratic accountability and legitimacy of the Eurozone. In his article on *Democratic Accountability and the Exchange-Rate Policy of the Euro Area* Randall Henning examines the consequences of the political 'incompleteness' of the monetary union for the democratic accountability of its external monetary policy, comparing the euro area to the US.

Henning notes that accountability in exchange rate policy is weak compared to other policy areas in almost every country. Exchange-rate policymaking is often delegated to the finance ministry and central bank – two institutions over which other domestic actors have little oversight. Although the rationale for delegation is compelling, he maintains that oversight and accountability by outsiders, especially the legislature, are still desirable, feasible, and appropriate in democratic systems. Moreover, the democratic accountability of exchange rate policy is important to maintaining political support for economic openness in general. According to Henning, in the US the Congress provides the possibility for 'democratic override' when policy diverges substantially from the preferences of a broad set of societal interests. In the euro area, the ECB and Eurogroup operate without effective external review or potential sanctions for departing even in the extreme from such preferences.

Henning supports his argument by contrasting the responses of the US and the euro area toward Chinese foreign exchange intervention during 2002–2006. He finds that the weakness of accountability within the euro area has two negative potential effects. First, it tends to bias remedies for undervaluation of third currencies toward trade measures and away from exchange-rate measures and could thereby erode political support for economic openness more broadly. Second, if exchange rate policy deviates from societal preferences repeatedly, the weakness of accountability could leave the euro area at risk for an erosion of legitimacy over time. Until the political project of the European Union is completed, Henning suggests that policy makers should compensate for the weakness of accountability by providing greater transparency, soliciting the views of societal groups, the Parliament and the Commission on external monetary policy, and developing a more robust inter-institutional dialogue.

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Political economists have long raised concerns that EMU's asymmetric institutional design, which is built around a single independent supranational central bank and decentralized system of fiscal governance with 13 (soon 15) national authorities, leaves the project's legitimacy vulnerable to fluctuations in the perceived advantages and disadvantages of the euro. The difficulty is exacerbated by the confusion over the way in which the public should evaluate EMU. Should it be judged on its ability to deliver economic growth, macroeconomic stability, or job creation?

In their article on *The Legitimation of EMU: Lessons from the Early Years of the Euro,* Servaas Deroose, Dermot Hodson and Joost Kuhlmann suggest that although popular support for EMU remains strong after seven years of the single currency, it has varied at the member state level. Support for EMU appears to have been closely related to popular attitudes about the euro's utility and perceived – rather than actual – economic performance. In particular, the perception that the euro currency changeover raised prices, though not supported by the data, appears to have weighed heavily on EMU's legitimacy. This effect is pronounced in Germany, the Netherlands and Portugal, and to an even greater extent in Greece, Italy and Spain. Survey data suggests that those viewing the euro as advantageous tend to focus on the single currency's benefits for travel and trade and on its political advantages for Europe rather than its contribution to greater macroeconomic stability and historically-low interest rates.

The implications of these findings are three-fold. First, economic and monetary authorities need to pay due regard to the legitimacy of policy making as well as to its efficiency and credibility. Second, the gap between EMU's perceived and actual economic impact reinforces the role of euro area economic governance in promoting greater understanding of the single currency's benefits and allaying concerns over its perceived costs. Third, EMU's legitimacy depends on more broad-based mechanisms rather than elite-driven and technocratic approaches to monetary integration.

Nowhere else among EU member states is EMU's legitimacy more challenged than in the UK. The only large member state that has opted out of the euro area Britain's possible future entry feeds much speculation. Will Britain ever adopt the euro, and if so when? The conventional view holds that British entry into monetary union is impeded by: opposition from large fractions of public opinion, business leaders, and the Conservative party; by insufficient synchronization of its economic cycle with the that of the euro area; by the sensitivity of Britain's foreign trade and investment to the single currency; and by the peculiarities of British political institutions. Because most of these influences change only slowly, many are very skeptical that Britain will join the single currency in the foreseeable future.

In his article on *How and Why Britain Might Join the Single Currency,* James Walsh argues that policy failure is a more important influence on British economic policy than is often recognized. Policy failure endangers the

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career prospects of politicians, and leads them to search for and consider alternative policy ideas. In turn, these ideas determine the goals for policy and frame expectations about the effects of different policies. Politicians select and seek to implement a rival idea, *ceteris paribus*, that identifies causal mechanisms that explain recent failure and offers an intellectually coherent and politically attractive set of policy prescriptions. Thus, major changes occur when an existing policy fails and new ideas are available to shape a replacement.

Walsh argues that a sharp deterioration in British economic performance, blamed on the current British policy framework (central bank independence and a floating exchange rate), combined with a perception that euro membership would address this failure, could improve the attractiveness of euro membership. This combination could in a short period of time lead many politicians, business leaders, and voters to see the advantages of euro membership and encourage a British government to advocate euro membership. Potential examples for such a combination include a sustained depreciation of the British pound, higher inflation or unemployment in the UK compared with the Euro-zone, or slower growth. Walsh supports his argument by analyzing British policy failures since the 1970s, including the failure of demand management in the 1970s, the Medium Term Financial Strategy in the 1980s, and the EMS in the 1990s. Thus, Walsh seems to imply that legitimacy is a relative concept and in times of crisis the single currency may suddenly re-emerge as a legitimate alternative. However, if an economic meltdown in the UK is unlikely, EMU's 'relative legitimacy' still depends on reforms that will successfully resolve the challenges of ambiguous governance, legitimacy and accountability.

This special issue originated in a panel held at the Ninth Biennial International Conference of European Union Studies Association (EUSA), which took place in Austin, Texas in Spring 2005. A workshop, organized by the editors of this special issue, followed in December 2005 at the SAIS Bologna Center of the Johns Hopkins University. The editors are grateful to the SAIS Bologna Center for hosting and sponsoring the workshop and to the Parachini family for generously providing the financial support. Some of the participants in the workshop later dropped out or their articles were rejected during the refereeing process at *RIPE*; we thank both them, and the contributors to this special issue, for having delivered punctually their original and thought-provoking articles. Most of the logistical side of the editorial work was carried out by the Bologna Center's staff, particularly Sarah Bignami. *RIPE's* editors were forthcoming and supportive of the idea of this special issue from the start. We thank them all.

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