

# **THE EU'S COURSE HOW DEEP A UNION?<sup>1</sup>**

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## **PREFACE**

This project explores potential avenues for the European Union after the economic crisis and analyses the impact of different future scenarios on the EU in general and Finland in particular. The main objective of the project is to provide tools for Finnish decision-makers and, at the same time, to facilitate a wider public debate on the future of the EU in Finland.

A central assumption behind the project is that the current financial and economic crisis has underlined the link between the economy and politics. On the one hand, the crisis has led to a series of extraordinary political measures. On the other hand, the political decisions that have been taken as a result of the crisis will have far-reaching economic consequences. This means that in order to fully grasp the crisis and its implications, a multi-disciplinary approach is needed. Accordingly, a central goal of the project is to foster the dialogue between economists and political scientists.

The project is being carried out jointly by the Research Institute of the Finnish Economy (ETLA) and the Finnish Institute of International Affairs (FIIA), with researchers from both institutes participating in the actual research work. The project is headed by Research Director Markku Kotilainen from ETLA and Director Teija Tiilikainen from FIIA.

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**SUMMARY:** The report analyses and assesses different alternatives for the development of the European Union as well as their implications for both the EU itself and Finland. The analysis is based on different political and economic scenarios. At the heart of the first scenario are the various measures the EU has already undertaken in order to combat the eurozone crisis and to strengthen the EMU. We call this scenario the “Banking Union EMU” because its central innovation is the banking union. The second scenario is built on the assumption that the EMU will be deepened by extending mutual liability and by reinforcing the established rules for responsible budgeting. These reforms will, however, be implemented without radically altering the current political and institutional set-up of the EU. An important step in this scenario is the establishment of mechanisms for counter-cyclical fiscal policy in the eurozone. This requires the creation of a euro area fiscal capacity. A further possible step is the introduction of a system of mutual debt. We label this scenario the “Fiscal Union EMU” because the crucial reforms in this scenario revolve around the EU's fiscal policy. The scenario requires amending the EU's current treaties and institutional architecture. The third scenario looks at the possibility of transforming the eurozone into a constitutional federation. This scenario would mean a vast expansion of the EU budget as well as the transfer of new powers to the federal level particularly in the area of economic and fiscal policy as well as in the field of foreign and security policy. This scenario would involve a thorough overhaul of the EU's current legal and institutional framework. The EU's treaties would be replaced with a constitution that would make the Union a sovereign actor. We call this scenario the “Federal EMU”. In the end, we also briefly discuss the possibility of disintegration in the euro area. Some form of disintegration could take place simultaneously with one of the three above-mentioned scenarios.

**Keywords:** European Union, Economic and Monetary Union, EMU.

## What is studied and how?

This report examines development options of the European Union (EU). It focuses on the Economic and Monetary Union (EMU) and the reforms set into motion by the European financial and sovereign debt crisis.

The rapidly expanding crisis that started in 2009 brought a halt to the favourable economic growth period following the introduction of the common currency in Europe. In the autumn of 2011 and again in summer 2012 the disintegration of the euro area was a topic of serious public debate. Extraordinary measures were taken to restore financial stability and defend the common currency. Large-scale conditional financial assistance packages were customized for the crisis countries. They represented a deviation from the principle that each member is solely responsible for its own public debt. The European Central Bank also resorted to extraordinary measures and its promise to purchase government bonds under certain conditions (laid out in its Outright Monetary Transactions programme) was an important factor in calming the crisis from the late summer of 2012 onwards.

Simultaneously, economic policy co-ordination within the EU and the eurozone in particular has been increased. The rules concerning economic discipline have been tightened and extended beyond the management of public finances. In the future it will be easier to apply various sanctions to euro area countries if they do not comply with the agreed rules. Banking regulation has been tightened, and supervision of regulations and crisis management is being shifted from the Member States to euro area level.

Measures concerning crisis management and financial development have proven to be politically difficult. Decisions regarding aid and the new financial instruments have been heavily criticized in the crisis countries as well as in those providing the financial assistance. In the crisis countries, the conditions for receiving the aid have been deemed unfair, whereas in the countries offering the financial aid the scope of the mutual responsibility is considered to be excessive and contrary to the principles of the Treaty of Maastricht.

Extraordinary crisis management measures and ongoing EMU reforms have highlighted dividing lines within the Union. In some Member States, the increasing solidarity and the shift of decision-making from the national to the EU level has been criticized. In other Member States, the tighter rules have been criticized for being too rigid and complying with them is estimated to result in poor economic development. In addition to discord, the crisis has led to the divergence within the Union. The division between countries belonging to the euro and member countries outside the monetary union has grown.

In addition to the already implemented and agreed reforms, proposals have been made for a series of reforms aimed at strengthening the EMU in both the medium and long term. Further reforms and strengthening common institutions have been regarded as vital in a number of forums to ensure the functioning of EMU. On the other hand, the economic benefits of such

proposals and the political possibilities of implementing them have been questioned. There has been a fear of the reforms leading to excessive solidarity and growing discord between Member States in addition to further increasing the segregation of the Union. The debate has also been coloured by dissatisfaction with the economic policy pursued by the Union and on a national level.

The objective of this report is to outline and assess the options of the EMU's development and their implications for the entire EU and Finland. We present three different scenarios or development models. The events outlined in these scenarios have been shaped by development trends in recent years, plans presented to strengthen the EMU, and the economic policy debate regarding these plans. The primary objective of the study is not to evaluate the probability of various development scenarios. The assessment of economic and political effects, however, also provides tools for this sort of debate, and we do not completely abstain from presenting views on the likelihood of different options.

The basis of the first scenario presented in the report (chapter 3) is the measures that have already been carried out widely to overcome the crisis and to strengthen the EMU. We call this option the "Banking Union EMU", because its most central comprehensive reform involves the establishment of a banking union. The analytical objective of the scenario is to evaluate the economic and political effects concerning the banking union and already implemented decisions.

In the second scenario (Chapter 4), the development of the EMU is expected to take place through increasing solidarity or mutual responsibility and further strengthening of the regulations set for economic governance, although still in a way that no large-scale changes are made to the political and institutional system. In practice this means, for example, the creation of tools for cyclical stabilization in the euro area and the necessary joint financial capacity, i.e. having the possibility to also incur debt or issue separately joint debt instruments. In this scenario the decision-making power over economic policy is shifted more towards the EU level than in the Banking Union EMU. The scenario can take on a wide variety of forms, depending on whether the emphasis is primarily on increasing solidarity or following rules agreed upon at the EU level. We call this model the "Fiscal Union EMU" because the key changes concerning mutual responsibility and decision-making power relate to the Union's fiscal policy. The model requires limited reforms of the current EU treaties and institutions.

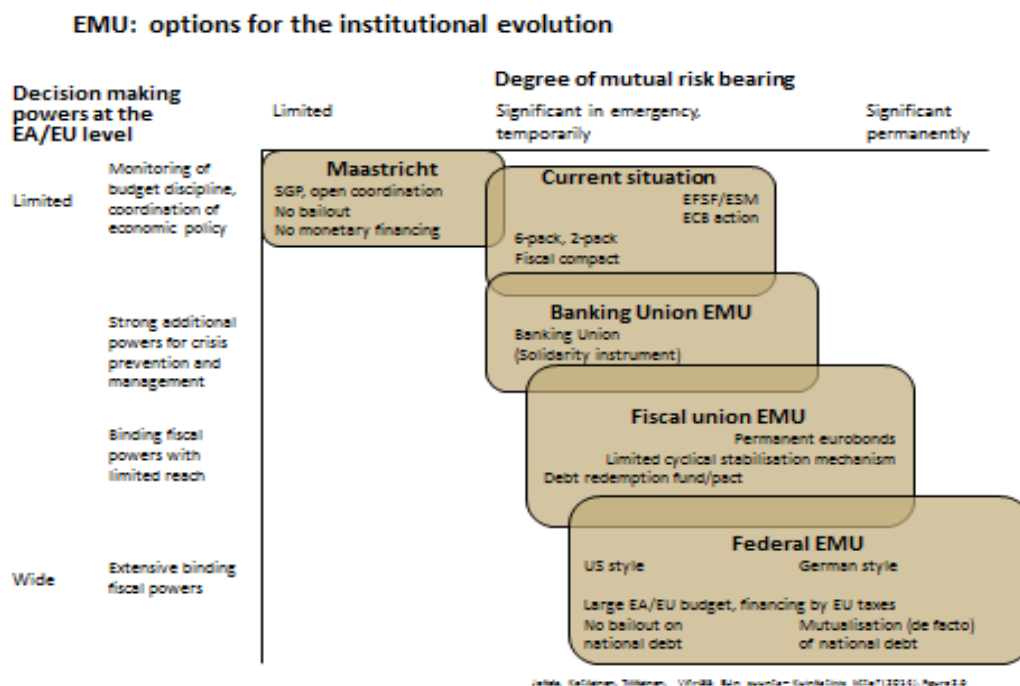
The report's third scenario (Chapter 5) is based on the emergence of a federal constitutional framework within the euro area. In this alternative, the Eurozone budget increases significantly and new decision-making power is shifted to the federal level particularly in fiscal and other economic policies as well as in foreign and security policy. The present form of the EU's legal and institutional framework is thoroughly reformed and treaties replaced by a constitution, defining the federation as a sovereign actor. We call this model the "Federal EMU".

Fourth, we assess a variety of EMU disintegration scenarios in chapter 6, evaluating them mainly on a relatively general level. This alternative scenario differs from the other three as it may take place in tandem with the development models described above.

The scenarios presented in the report are structured so that they are clearly distinguished from each other based on the main characteristics. The function of the clear-cut development options is largely analytical. The assessment of straightforward models is easier. In practice, the realized alternatives can be combinations of the different models examined.

The scenarios are evaluated with respect to their economic and political effects taking into consideration their sustainability and key instability aspects related to them. In economic terms, the main issues are how the different scenarios affect financial stability and efficiency. From a political point of view, the efficiency and democratic legitimacy of the options as well as how they relate to the EU's political dividing lines are important elements of the analysis.

The construction of the models and the assessment of their impacts have been carried out utilizing a multidisciplinary approach. This means that the research is based on the hypotheses and literature of both economics and political science. Legal literature and experts and officials who have followed EMU reform projects closely have also been consulted in the building of the models and in the assessment of their impact. The work of defining the scope and analysing the development scenarios was carried out by the authors of the report. The material used in the analysis contains mainly official documents, available research literature, and policy-relevant research papers commissioned from experts in various fields.



## Conclusions

The financial crisis highlighted the difficulties with the old structures of the EU and the euro area, in particular. There are good grounds for saying that the structures contributed to the present crisis, and that they also slowed down the recovery from the crisis. Bringing the crisis under

control and preventing the disintegration of the monetary union has necessitated exceptional measures and the creation of new institutions. The changes have also affected the roles of EU institutions. They have meant greater mutual responsibility, stricter rules on the fiscal policies of Member States and shifting the decision-making from individual Member States to the euro group or EU institutions. Despite this, the vast majority of the decisions affecting countries' economic development are still carried out in the Member States, and especially the budgetary power is still in the hands of the Member States themselves.

The key question is whether the newly emerging structure that we call the Banking Union EMU is sustainable, and if not, what kind of alternatives can realistically be deemed to exist.

The realization of the EU development scenarios will depend in a complex way on economic and political developments in Europe and in the world as a whole. Some of these factors may in the actual decision-making situations be regarded as more or less exogenous factors, i.e. factors that policy-makers cannot directly affect. Policy choices are often shaped by situations where it is thought that something has to be done.

Developments are also driven by values independent of direct pressures to change and by views of the preferred Europe. Many political actors have their own vision of a desirable course of development for the EU. They are promoting their own policy, sometimes in a transparent manner and sometimes covertly. The EU's institutions have become significant political forces guiding the development of the Member States and their domestic political actors as well as the general trends in the Union. During the economic crisis, the core of this group was formed by the European Commission, the European Parliament, the European Council as well as the European Central Bank.

It can be said that – broadly speaking – the EU's southern and western countries, with their Catholic heritage, are more willing to promote solidarity and a tighter EU. This is reflected in their political cultures. For example, the French have been used to favouring state-led solutions (so-called dirigisme) in economic issues. The French attitude towards the EU's future development is, however, ambiguous. On the one hand, the country has strong traditions emphasising solidarity and European cohesion. On the other hand, the French are strict about their own decision-making power and sovereignty in general because of their history as a great power.

North Europeans, who have been living in the sphere of the Protestant religion and the associated state-oriented political thought, place more emphasis on each country's own responsibility for their finances. These countries also emphasize the importance of market forces as equilibrating mechanisms in the economies and in efficient allocation of resources.

Although Germany emphasizes that each country is responsible for its own finances, Germany also has a strong European tradition, by virtue of which on certain issues the Germans are ready to take the EU in a federalist direction. Here, too, limiting of financial solidarity is usually set as a goal reflecting, above all, the size of the country and the extraordinary contribution to the Union's common resources. With respect to Germany and France, it has been said that when they find a



compromise on core issues of EU policy, the compromise is often so extensive that it is easy for the other Member States to agree. This also holds true for numerous issues regarding a deeper EMU.

In the UK the individual-oriented political culture and the legacy of political and economic liberalism produce a negative view of strengthening state institutions at the national and European levels. The British desire for an EU that safeguards the economic freedoms of individuals focuses on the single market and leads to a negative stance towards a political union in the first place.

In addition to these deep cultural dimensions, traditional ideological divisions are reflected in the European political stances. European left-wing parties are, in principle, more in favour of political solutions than market-based ones. In this regard, there are nevertheless differences between the parties in different countries. Northern European left-wing parties are often more pragmatic than the southern European left-wing movements linked more closely to the European idea.

The economic and political situation prevailing at any given time affects the policies followed by different countries. French politics has traditionally been guided by the desire to reduce the weight of unified Germany by highlighting common European solutions. France has sought to tie Germany's policies closely to common European solutions. It is natural that currently in the EU crisis countries there is a prevalent desire to steer the EU in the direction of greater solidarity, since these countries would benefit directly from this. They also have, on the other hand, the cultural capabilities to carry this out. As the crisis passes, the situation may nevertheless become more complicated.

The EU is known to have taken crucial development steps in the midst of various crises, and the economic crisis has had a significant impact on the choices at hand. On the one hand, the crisis has forced a re-evaluation of the structural solutions that were chosen when the EMU was created. The crisis has raised fundamental questions about the scope of EU solidarity underlying the political union and thus the nature of the entire political union. In part of Europe the widening of solidarity has nevertheless been accepted only as far as considered necessary in order to prevent chaos. On the other hand, the survival of the currency union, which until the crisis was considered a quite successful project, has strengthened the political will, in principal, to shift power from the Member States to the Union, in some cases even resorting to federalist solutions. In this respect, the intensifying global competition with regards to the economy as well as politics has similar effects, thus encouraging closer co-operation within the EU.

Each of the EU's future scenarios described above has its own weaknesses and strengths from both the European and the Finnish points of view. We list the pros and cons alongside each of the scenarios described in our book mainly from the EU's political and economic system's point of view. Deeper analysis would naturally require specification of the political or ideological viewpoint from which the scenarios are evaluated.

## EU development scenarios: pros and cons

Scenario	Pros	Cons
Banking Union EMU	<ul style="list-style-type: none"> <li>- More stable than Maastricht EMU,</li> <li>- More effective monitoring of compliance with the rules and sanctioning of violations</li> <li>- Changes easy to implement</li> <li>- Market mechanisms still have steering impact</li> </ul>	<ul style="list-style-type: none"> <li>- Complex division of power between the Union and the Member States</li> <li>- Unclear responsibilities, relationships, and weak democratic control</li> <li>- Is it sufficient to stem new crises?</li> </ul>
Fiscal Union EMU	<ul style="list-style-type: none"> <li>- Cyclical stabilization measures and solidarity at EU level strengthen crisis resilience</li> <li>- Fiscal tools to address aggregate economic problems</li> </ul>	<ul style="list-style-type: none"> <li>- Threat of moral hazard in mutual responsibility</li> <li>- Strengthens the dividing line between the euro countries and the rest of the EU to the extreme</li> <li>- Problems with democratic control grow worse</li> </ul>
Federal EMU	<ul style="list-style-type: none"> <li>- Institutional dividing line is removed from inside the Union</li> <li>- Clearer separation of powers between the Union and the Member States</li> <li>- Strong common fiscal instruments reduce the threat of economic crisis</li> <li>- Strengthens functioning of Union, especially with respect to foreign relations</li> </ul>	<ul style="list-style-type: none"> <li>- Some EU countries remain outside the system with associate status</li> <li>- The system is rigid: it does not allow the current divergence</li> <li>- Threat of moral hazard and permanent transfers when solidarity carried out on wide scale</li> <li>- Risk of political backlash and conflicts if there is no genuine cohesion</li> </ul>
Disintegrating EMU	<ul style="list-style-type: none"> <li>- Countries and groups of countries are divided into optimal currency areas</li> <li>- Spread of EU countries' crises from one country to another weakens</li> </ul>	<ul style="list-style-type: none"> <li>- Disintegration process is likely to be chaotic</li> <li>- EU's economic and political power is reduced</li> <li>- Foreign trade between EU countries may suffer from emergence of new exchange rate costs</li> <li>- Danger of partial optimization: less taking into consideration of EU's common interests</li> <li>- Crisis management is externalised between countries (threat of currency crises)</li> </ul>

From Finland's perspective, the realization of the Banking Union EMU does not entail serious economic or political problems. If the scheme is successful in stabilizing the euro area's economic development, it will also reduce the risks facing Finland and bolster conditions for domestic growth. Assuming that Finland will be able to manage its own finances properly, stricter financial

discipline will not be a constraining factor for Finland, and it will not need to resort to financial aid and as a result be forced to forfeit some of its sovereignty.

The unclear division of economic and fiscal policy power between the Union and the Member States addressed by the Banking Union EMU - and the consequent challenge for democratic legitimacy - is a potential problem. Another political problem with the scenario is Finland's more distinct separation into a different reference group from its northern EU neighbours, in particular Sweden. This will have adverse consequences for Finland from the perspective of economic and political cohesion and influence.

The implementation of the Fiscal Union EMU in a limited fashion as a rule-oriented version would be relatively trouble-free for Finland. The fiscal stabilization mechanisms would help to offset the economic fluctuations, which could be a significant advantage to cyclically sensitive economies such as Finland. If cyclical stabilization can be carried out without any permanent transfers or joint debt, the moral hazard effects could be minimized. A limited and temporary joint debt scheme, for example in the form of a so-called debt redemption fund, if implemented well could reduce the risk of high debt in EU countries without leading to a permanent moral hazard problem. Such a system could on the whole be useful for Finland if it successfully prevented the eurozone debt crisis from escalating once again. On the other hand, the wide-scale implementation of joint debt would be likely to increase joint responsibility in a way that Finland could be affected by the possibly poor decisions of other EU countries.

The political problems with the Fiscal Union EMU would largely be the same ones for Finland as in the Banking Union EMU, yet they might become greater. It is questionable whether the Union's current democratic mechanisms would be able to provide adequate legitimacy for these developments. Relatedly, the dividing lines within the Union and a further polarization of public opinion about the EU might grow stronger. An important question in this context is how the increased segregation of Finland's and Sweden's EU obligations would affect the acceptability of the Union in Finland.

The Federal EMU would be problematic for Finland. In Finland, the debates related to European federalism are rather new, and the federalist solutions are largely perceived as quite distant. While the scenario would not mean such drastic changes in many policy areas as is commonly thought, there would be essential changes compared to the current situation with respect to the separation of powers in economic and fiscal policy as well as foreign, security and defence policy. In addition, the Federal EMU's lack of flexibility in terms of multi-speed integration would be a noteworthy challenge to its emergence. The Federal EMU would alleviate the institutional tensions between the euro area and the rest of the EU, which would most likely lead to division of the current EU. The federation would be comprised of the Europe's tight-knit euro core, but it is rather obvious many current EU Member States would decide not to join in to the federation. . The situation of those remaining outside would probably resemble that of the current non-EU EEA countries. For Finland it would be an especially problematic situation if Great Britain as well as Denmark and Sweden remained outside the federation, which is very likely. If the Federal EMU is

realized, Finland will have to carefully weigh the costs and benefits of associate membership in the EU. In Finland, this solution would be politically very difficult.

Disintegrating EMU is to be seen as a crisis scenario which very few people are actively advocating. While this scenario may for some countries be economically justified as an end result, countries deeply integrated with Germany can under all circumstances be expected to stick with the single currency. In any case, even a partial disintegration process would most likely be chaotic. The mere threat of the break-up of the euro area has spawned the multi-year euro crisis. If the disintegration of the Eurozone is considered likely in Finland, one should prepare for the event very well.

At the time of writing, the EU is taking the form of the Banking Union EMU, and the previous discussion on the disintegration of the EU or the euro area has so far remained in the background. Also, the most radical visions of a complete overhaul of EMU have waned.

Germany continues to back – albeit in a slightly more muted fashion – the reopening of the EU Treaties. The reopening of the treaties will send a political message that there is discontent with the current distribution of power, in which case there is evidently a need to seek change via more wide-ranging treaty reforms. Is the rest of the EU or even Germany ready to reopen the Banking Union EMU sparked by the economic crisis and launch a political process that may include important new steps toward the Fiscal Union EMU or even the Federal EMU?

If financial market tensions continue to ease, the debt problem can be managed and growth continues fairly steadily, the economic pressure for new solutions will remain small. In this case, it is very possible that the Banking Union EMU will be quite a long-term solution. If, on the other hand, the crisis intensifies again, taking of new steps towards closer integration will be put back on the agenda as an alternative to a disintegration of the Union at least in some degree.

In recent years the main impetus behind changes in the European Union has been the weaknesses in its structure revealed by euro crisis. To correct these defects reforms have been taken that were deemed almost impossible by many still in the spring of 2010. It is an open question how much the overhaul of the EU so far decided upon will help in solving Europe's economic problems. If the situation with regard to direct economic pressures begins to settle down, the direction of the EU in the coming years may be steered more by political than economic factors, such as the development of the neighbouring regions and the aspirations of other centres of political power.