ENLIGHTEN

EUROPEAN LEGITIMACY IN GOVERNING THROUGH HARD TIMES: THE ROLE OF EUROPEAN NETWORKS

HORIZON 2020 COLLABORATIVE RESEARCH PROJECT 2015-2018

RESEARCH BRIEF

WORK PACKAGE 2

BANKING CRISIS AND FINANCIAL STABILITY

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RESEARCH AIMS

As the crisis experience has made amply clear, financial stability and fiscal viability of member states are closely – even dangerously – connected. Because of this link, they are together defined here as ‘financial sustainability’. In the European response to this twin banking and sovereign debt crises, governance and supervision and fiscal policies are tightly linked and coordinated. A first set of policy responses related to banking supervision and macro-prudential oversight of the financial sector, most notably the creation of a Banking Union and the European System of Financial Supervision. The second set of policy responses related to financial assistance for certain Member States and mainly concerned the Economic Adjustment Programs (e.g. for Greece) and the setting up of the European Stability Mechanism and its predecessors. A third set of policy responses, which this research part is especially interest in, related to the reinforcement of the economic governance framework for macroeconomic and fiscal surveillance.

The institutional architecture that has been erected to support these policies is complex and reveals its tensions and complementarities, including the establishment of the European Stability Mechanism and the Fiscal Compact outside the legal framework of the EU. That has made governing the intersection between financial services policy (regulation and supervision of financial institutions) and monetary and fiscal policy for EU members highly complicated, and challenging to legitimize in terms of input, output and throughput processes. Besides, the research also looks at which expert networks have been involved in decision-making and which ideas and solutions have become predominant in their discourse. The discussion on the underlying strategy of the economic governance framework seems to have converged in what is known as the ‘holy triangle’ of fiscal consolidation, structural reform and investment. After a short period of counter-cyclical policy in many MS at the offset of the crisis in 2008-2009 (European Economic Recovery Plan) followed a long period of austerity in the EU. Member States were repeatedly urged to adopt ‘growth friendly structural measures’ drawn from a limited and familiar menu: pension reform, improvements to public administration, changes to wage-setting institutions, and measures to liberalize the services sector and network industries.

In consequence, this part of the ENLIGHTEN research investigates four areas in particular : 1) the European Semester and the Macroeconomic Imbalances Procedure (MIP) as institutional responses to unsustainable public finances and related macroeconomic challenges; 2) Financial regulation, with an eye to promoting financial stability; 3) European tax policy, with regard to potential erosion of tax bases and 4) Expert networks in central banking and the relationship between expertise and European modes of governance.

MAIN HYPOTHESIS

Four hypotheses have been developed in relation to banking crisis and financial stability:

1. The euro crisis underscored the interdependence of European economies and highlighted weaknesses in the economic governance framework. In particular it showed the existence of huge macroeconomic imbalances and the fact that previous years of economic growth had not led to sufficiently strengthened budgetary positions in most Member States. During the crisis therefore a broad set of measures was introduced in order to preserve the single currency and strengthen the governance framework. These included the Six-Pack, the Two-Pack and the Intergovernmental Treaty on Stability, Convergence and Governance (TSCG). The Six-Pack reformed both the preventive and corrective arms of the Stability and Growth Pact and established the Macroeconomic Imbalance Procedure (MIP) aimed at preventing economic imbalances. It furthermore introduced a new graduated system of sanctions for euro area countries; an expenditure benchmark to assess progress towards medium term objectives; it further specified how the debt criteria should be applied and finally it introduced the European Semester and a framework for national fiscal surveillance. This research assumes that the MIP is less coercive than critics claim but also less effective than its champions hope. The main potential it holds for addressing European crises lies in setting broad goals and letting member states work towards their fulfillment on their own terms.

   The euro crisis is not just the result of a crisis in public debt but is part of a much wider set of macroeconomic and financial developments that are now monitored in a streamlined process called the European Semester. The European Semester brings together the various innovations in economic governance as described above and includes several European strategies, most notably the EU2020 strategy and the Euro Plus Pact, whilst also including more specific policy documents relating to e.g. financial sector sustainability or poverty reduction. It furthermore involves a complex web of interactions between the Commission and various national, European and civil society actors and is based on a collaborative process between various DGs within the Commission itself. This research assumes that the Semester may have an in-built bias overemphasizing fast-burning crisis (e.g. fiscal imbalances) at the expense of attention to slow-burning ones. It also starts from the premise that when looking closely at the dynamics and evolution of the European Semester, terms like supranationalism or intergovernmentalism fall short of fully explaining the web of interaction that has been created. The research assumes that the Semester represents less of an institutional big bang than perhaps initially presumed. Even thought it can have a strong disciplinary effect, the main mechanism for enforcement remains dialogue, enhanced monitoring and peer pressure. This research argues that the Semester should be studied as a process, still evolving.

2. Policymakers and members of civil society overestimate the ability of regulation to banish financial instability by itself in an adverse macroeconomic context (low growth, ultra-low interest rates). The regulators employed to combat short-term financial instability may have adverse long-term consequences. In combating financial market pro-cyclicality policymakers face a structural dilemma between a stringent enforcement of rules and between giving financial firms enough flexibility/discretion to cope with financial turmoil. Studying these policy areas will also allow researchers to ascertain to what extent EU-policy makers succeed in devising rules that limit instability. Preliminary findings suggest that progress has been limited, but that this is not necessarily due to regulatory mistakes but rather by the fundamental limits of governing inherently unstable markets.

3. Tax reform is high on the European policy agenda, with many politicians and policymakers seeking to plug 'fiscal leaks'. Politically the European institutions must manage a process acceptable to European member states, some of which are heavily involved in providing 'tax efficiency' services. Expert battles are raging between policymakers, practitioners, and activists over how to reduce corporate tax avoidance and evasion, as well as how to harness a tax system that contributes to European economic competitiveness.

4. The International Monetary Fund's lack of success in convincing the senior partner in the Troika (the European Central Bank) of the need to embrace the Fund's Keynesian calibration of fiscal policy doctrine. This is puzzling in the light of the IMF's unchallenged expertise on balance of payments crises, its institutional and professional proximity to the ECB and growing evidence that the ECB's fiscal policy ideas inspired self-defeating policies in the countries struck by the crisis. This brings in the concept of firewall from diffusion studies: strong firewalls, it is argued, dilute incentives to adopt the innovation, reinforcing the immunity against diffusion of the target of diffusion, in this case the ECB. Expert networks have also played a critical role in the constitution of the ECB's firewall of counter-diffusion.

RESEARCH METHOD

The following methods have been tailored to each topical research addressed in this part of the research:

1. Macroeconomic Imbalance Procedure

   This project is based on two qualitative methodologies. The first consists of a qualitative content analysis of recommendations issued by the European Commission to Member states in regards to the MIP. This analysis will reveal the evolution over time of both the uniformity and the prescriptiveness of the recommendations. The second traces the evolution of debates about macroeconomic imbalances over time in five cases. It will chronicle these through the use of policy documents and personal interview to establish the dynamics and mechanisms in the implementation process of the Country-Specific Recommendations as well as the coerciveness of the measures taken by the Commission in case of non-compliance; the cases are compared to attribute commonalities to the workings of the MIP where possible.

2. Financial regulation

   This project employs the method of process tracing, studying the unfolding of events over time in key regulatory episodes. It is based on a thorough analysis of policy documents, the academic literature on and reporting in the specialized press. This is supplemented by interviews with key stakeholders/experts/private sector representatives in these domains, apart from the policy makers/supervisors themselves.

3. Tax reform and emerging innovative ideas

This part examines how institutional actors coped with the crisis both quantitatively and qualitatively. The quantitative part of the approach combines content analysis of policy documents and interview transcripts, sequence analysis of the careers of those involved in institutions and networks, network analysis of how actors interact and relate to each other, and event history analysis which models the relationship between events (survival) and time to understand the effect of the policies on the European public. The combination of these methods will explain why some ideas and/or knowledge prevailed while others receded in the background, as well as how actors' institutional positions and resources shape the fate of crisis resolution scenarios. In addition to these methods, the qualitative methods employed concentrate on discourse analysis and process tracing, including semi-structured interviews with key individuals in the different institutions and expert networks about their changing perceptions of the crisis, of the policy responses, of whose ideas mattered over time as well as their perceptions of whose ideas mattered and why. The interviewees are selected based on the results of the network analysis, which will identify the central nodes of the policy networks that governed the crisis.

4. The IMF and the ECB

This part combines three methods: content analysis performed on studies cited by the regular reports of the IMF and the ECB; network analysis of the affiliations of the economists cited in the coded policy documents and regression analysis performed on the ensemble of the professional experiences of these economists. The strength of this methodological mix (CANARA) is that it enables more systematic evaluations of how the ideas, professional experiences and institutional positions of the transatlantic networks of economists the IMF and the ECB appealed to during the tumultuous years of the crisis. To undertake a systematic comparison of the ideas and professional fields of the 569 economists whose work was cited in the official doctrinal statements of the IMF and the ECB (the European Commission's papers do not cite economics research with identifiable authors) this methodology is applied to analyze IMF's World Economic Outlook Reports and in the ECB's Monthly Bulletins from January 2008 through December 2015. The dataset is already complete for the 2008-2013 period.

CASE STUDIES

For this research several cases have been selected according to the four main areas of investigation:

1. On the Macroeconomic Imbalance Procedure and its coercive leverage:

   - The housing market in the Netherlands
   - Public/private investment in Germany
   - The mechanism for wage-setting in Belgium
   - The French labor code
   - Italian product and services market liberalization

2. On financial regulation and attempts to limit financial market instability and pro-cyclicality.

   - The European regulation of accounting standards
   - The regulation of credit rating agencies
   - The implementation of a macro-prudential framework

3. On tax reform and its key expert networks

   - Tax lawyer networks in Europe
   - Activist networks on tax reform
   - Role of professional service firms in European taxation

4. On the ECB's "firewall"

   - Economists and lawyers on shadow banking issues in Europe
   - Accountability mechanisms in the European economic institutions
   - Discourse formation among European central banks

SCIENTIFIC IMPACT

The various aspects of this research provide central, overarching scientific contributions on the banking Union and financial stability. For the ENLIGHTEN research as a whole, the work highlights that temporal aspects are key in policy effectiveness. On the Macroeconomic Imbalance Procedure in particular, research shows that implementing this mechanism is very different from conceiving it in theory. Reasons for that include the importance of informal agreements, incomplete information in the hands of policymakers, regulatory dilemmas and the importance of unacknowledged paradigms guiding collective deliberations. The work thus shows the importance of studying European policymaking empirically instead of relying purely on formal flows of decision-making. Finally, the research outlines potential weaknesses in policy-making arrangements in crucial fields without falling into the trap of a black-or-white portrayal of EU policy in these fields.

SOCIETAL IMPACT

What is at stake for the societal relevance of this work is the sustainability of European and national public finances, as well as the stability of financial markets. The research on the Macroeconomic Imbalance Procedure is obviously based on direct interactions with non-academic counterparts enabling a wide societal impact (exchanges with Commission officials, visits to workshops and seminars by think tanks such as CEPS/Bruegel/Clingendael, speeches by Dijsselbloem, Drombovskis or Moscovici, etc). The research on financial regulation has also been shaped by current events in financial markets and regulatory policy, by discussions with Finance Watch and by their interaction with policymakers through previous work for the Dutch Scientific Council for Government Policy. The research on tax reform is being made in close cooperation with Tax Justice Network. Both UVA and TJN recently published a co-authored piece in the British Journal of Politics and International Relations. The research on the ECB has also been discussed in depth with Finance Watch and other NGOs such as Transparency International.

For Tax Justice Network and Finance Watch, this research has been the occasion to find new angles for analysis and approach issues from distance, exploring the bigger conceptual framework defining the environment in which they operate. This academic input is precious for their advocacy.

PEOPLE INVOLVED

- UNIVERSITEIT VAN AMSTERDAM (UVA)
- COPENHAGEN BUSINESS SCHOOL (CBS)
- TAX JUSTICE NETWORK (TJN)
- EUROPEAN TRADE UNION CONFEDERATION (ETUC)
- FINANCE WATCH (FW)

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