TEN YEARS OF THE EU ECONOMIC GOVERNANCE AND ITS REFLECTION IN CZECHIA

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Abstract

Even if the new 'post-crisis' form of economic governance arose for clear reasons - to achieve economic convergence between the eurozone states in an environment where previous decision-making models were inappropriate or undesirable - the question is whether it is also suitable for the current member economies of the European Union in the third decade of this century. During the crisis, it became clear that there are connections between macroeconomic imbalances not only in individual member states, but also at the level of the European Union. However, the institutional prerequisites were not sufficiently elaborated, and it was necessary to strengthen them. The rules of economic coordination were included in the European Semester. The reform of the EU economic governance must respond to the turbulent development of the present time with a reform built on the commitments associated with green and digital transformation. The article seeks to contribute to the current discussion on this urgent topic. The aim of the published article is to contribute to the discussion, which should result in the formulation of priorities within the EU, but also of the government of the Czech Republic in its economic policy. Methodologically, it relies on descriptive analysis, deduction, and induction.

Keywords

Economic Governance, Macroeconomic Imbalance Procedure, European Semester, Green and Digital Economic Transformation

I. Introduction

The European Union comes from the autumn of 2022 with the intention of reforming the management of economic governance, which has been applied for more than ten years, aimed at maintaining balanced macroeconomic development in the member states. Following this, the European Commission presented a package of legislative proposals on 26 April 2023, which containing proposals for a comprehensive reform of the existing economic governance rules. The EU economic governance framework aims to balance the autonomy of member states with the need for coordination and convergence. It seeks to ensure economic stability, foster sustainable growth, and strengthen the resilience of the EU economy. The economic governance reform proposal should consider both the long-term commitments of the European Union (e.g., in carbon neutrality or digital transformation), but also other challenges, such as requirements to increase defence spending or the participation of EU countries in the reconstruction of post-war Ukraine. The proposal should also consider the specifics of individual member countries in achieving the sustainability of their public finances. However, as Stiglitz (2020) notes, good governance must be based on the few simple principles of representativeness, legitimacy, transparency, and accountability.

II. European Union economic governance

The term governance was adopted into the official terminology of the European Union as an expression of the fact that international politics is not only a matter for states, but also for supra-state and sub-state entities, as well as non-governmental and non-state institutions, as stated by Cihelková et al. (2014). Economic governance is then an important concept corresponding

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to the basic aspects of the functioning of every company and its economic system. EU economic governance refers to the framework and mechanisms through which the European Union (EU) coordinates and manages economic policies among its member states. It aims to ensure stability, convergence, and sustainable growth within the EU's economic and monetary union.

The main pillars of EU economic governance include fiscal policy coordination, monetary policy, financial regulation, and structural reforms.

Fiscal Policy Coordination: The EU promotes fiscal discipline and coordination among its member states to maintain stability and prevent excessive deficits. The Stability and Growth Pact (SGP) sets rules for budgetary discipline, including the requirement for member states to keep their budget deficits below 3 % of GDP and public debt below 60 % of GDP. The European Semester is an annual cycle of economic policy coordination, where member states submit their budgetary plans for review and receive recommendations from the European Commission and the Council of the EU. It is an important policy framework in the European Union (EU) that coordinates economic and fiscal policies among member states. It was introduced in 2010 as a response to the global financial crisis and aims to promote economic coordination, convergence, and stability across the EU. The European Semester operates as a six-month cycle, during which the European Commission, together with the member states, reviews and provides recommendations on each country's economic and budgetary plans. The process involves setting out broad economic policy guidelines, analysing member states' stability and convergence programs, and issuing country-specific recommendations. The primary focus is on fiscal discipline, structural reforms, and promoting sustainable growth.

The European Semester has faced both support and criticism since its inception. Supporters argue that it fosters coordination and policy coherence across EU member states, encouraging them to take necessary measures to ensure the economic stability and growth of the entire region. It also enhances transparency and accountability in national budgetary processes. However, critics have pointed out various shortcomings. Some believe that the process lacks sufficient democratic legitimacy as it relies heavily on technocratic assessments by EU institutions. Others argue that the focus on austerity and strict fiscal discipline has been counterproductive, particularly in the aftermath of the 2008 financial crisis, as it can lead to prolonged economic downturns and social hardship. Additionally, some member states have perceived the European Semester's recommendations as an infringement on their sovereignty over economic policies.

Monetary Policy: The Eurozone countries share a common currency, the euro, and monetary policy is managed by the European Central Bank (ECB). The ECB's primary objective is to maintain price stability within the Eurozone. It sets interest rates and implements other monetary measures to control inflation and support economic growth. The ECB operates independently but coordinates with national central banks to ensure a consistent monetary policy across the Eurozone.

Financial Regulation: The EU has implemented various measures to regulate the financial sector and enhance financial stability. The European Systemic Risk Board (ESRB) monitors and assesses risks to the financial system, providing early warnings and recommendations. The European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) oversee the regulation and supervision of banks, securities markets, and insurance companies, respectively. Rules are created for Eurozone countries that are expected to be part of the banking union. The banking union is a key component of the European Union's efforts to strengthen financial stability and deepen integration within the Eurozone. It was established in response to the financial crisis that began in 2008 and aims to create a unified framework for banking supervision, regulation, and resolution.

The banking union consists of three main pillars:

- Single Supervisory Mechanism (SSM): The SSM, operated by the European Central Bank (ECB), is responsible for the supervision of banks in the Eurozone. It oversees the largest banks directly, while national supervisory authorities continue to supervise smaller banks. The SSM aims to ensure consistent and effective supervision across the Eurozone, reducing the risk of divergent practices that could harm financial stability.

- Single Resolution Mechanism (SRM): The SRM provides a harmonized framework for the resolution of failing banks. It is responsible for ensuring that bank failures are managed in an orderly manner with minimal disruption to financial stability and taxpayer burden. The SRM consists of a Single Resolution Board (SRB) and a Single Resolution Fund (SRF). The SRB develops resolution plans and has the power to initiate and implement the resolution process, while the SRF is a fund financed by contributions from the banking sector to support the resolution of failing banks.
- Deposit Insurance: The third pillar of the banking union aims to establish a common deposit insurance scheme to protect depositors in the Eurozone. However, the establishment of a common deposit insurance scheme is still under discussion, and currently, deposit insurance systems remain the responsibility of individual member states.

The banking union is intended to break the link between banks and sovereigns, strengthen the resilience of the banking sector, and enhance the stability of the Eurozone. By harmonizing supervision, resolution, and potentially deposit insurance, it seeks to ensure a more integrated and consistent approach to banking regulation and crisis management across member states. The establishment of the banking union has involved the adoption of several legislative measures, including the Single Supervisory Mechanism Regulation, the Single Resolution Mechanism Regulation, and the Bank Recovery and Resolution Directive. These measures aim to enhance financial stability, improve the functioning of the banking sector, and increase confidence in the Eurozone's financial system.

Another important element of economic governance is the rescue fund of financial aid for countries paying in euros - the European Stabilization Mechanism (ESM, popularly called as “Eurowall”). It is formally established by the eurozone states ad hoc and is subject to a board of directors, composed of the finance ministers of the eurozone member states. Its mission is to provide conditional loans to eurozone countries that become unable to pay their public debts on their own. The primary purpose of the ESM is to safeguard the financial stability of the euro area and ensure the stability of the common currency. It provides financial assistance to member states that are unable to access the financial markets at reasonable interest rates due to economic and financial challenges. The ESM has the authority to grant three types of financial assistance:

- Financial Assistance Facility: The ESM can provide financial assistance to member states in the form of loans. These loans come with specific conditions and are intended to support the implementation of structural reforms and fiscal consolidation measures in the recipient country.
- Precautionary Financial Assistance: The ESM can also provide precautionary credit lines to member states as a preventive measure. These credit lines act as a form of insurance, providing financial support to countries that have sound economic policies but may face potential financial market volatility.
- Bank Recapitalization: In certain cases, the ESM can directly recapitalize banks that are facing severe financial difficulties. This mechanism aims to prevent a banking crisis from spreading throughout the eurozone.

To receive financial assistance from the ESM, member states must meet certain eligibility criteria and agree to implement a set of policy measures to address their economic and financial challenges. The assistance is provided in coordination with other European institutions, such as the European Commission and the European Central Bank. It's worth noting that the ESM operates under strict governance rules and requires the approval of its Board of Governors, composed of the finance ministers of the eurozone countries, to provide financial assistance. Overall, the European Stability Mechanism plays a crucial role in maintaining financial stability in the euro area by providing financial support and promoting economic reforms in member states facing financial difficulties.

Structural Reforms: The EU encourages member states to undertake structural reforms to enhance competitiveness, boost productivity, and improve economic resilience. These reforms may include measures to promote labour market flexibility, encourage innovation and research, improve education and training systems, and enhance business environments.

III. How to reform the EU economic governance?

On 26 April 2023, the European Commission presented a long-awaited package of legislative proposals to reform the EU's economic governance rules (European Commission, 2023 a, b, c). The package contained proposals for two regulations and one directive. One regulation aims to change the effective coordination of economic policies and multilateral budgetary surveillance, and the other aims to speed up and make the implementation of the excessive deficit procedure more transparent. The aim of the proposed directive is to change the budgetary frameworks of the Member States so that they are in line with the new fiscal framework set out in the proposed regulations. According to the European Commission, the proposed rules aim to strengthen debt sustainability and promote sustainable and inclusive growth through reforms and investment (Theodoropoulou, 2023). Part of the economic governance reform is also a four-year medium-term fiscal structural plan, which each member state would prepare itself, which appears to be quite ambitious given the very asynchronous political cycles.

Reforming the economic governance of the European Union (EU) is a complex task that involves addressing various aspects of the EU's institutional framework and policy instruments. It´s possible to provide some general ideas and approaches that have been discussed in the past:

- Strengthening Economic and Monetary Union (EMU): The EMU is a central pillar of the EU's economic governance. To enhance its effectiveness, several measures have been proposed, including:
  - Completing the banking union by establishing a common deposit insurance scheme to safeguard bank deposits across the EU.
  - Creating a common fiscal capacity, which could involve a eurozone budget or a common unemployment insurance scheme to help countries during economic downturns.
  - Establishing a European Monetary Fund to provide financial assistance to member states facing economic crises, complementing the role of the International Monetary Fund.
- Enhancing Fiscal Discipline and Coordination: The EU's Stability and Growth Pact sets rules for member states' fiscal policies, but these rules have faced criticism for being too rigid or insufficiently enforced. Reforms could involve:
  - Adjusting the fiscal rules to allow for greater flexibility and differentiation based on countries' economic circumstances.
  - Strengthening the European Semester, the EU's framework for coordinating economic policies, to improve the effectiveness of policy coordination and address macroeconomic imbalances.
  - Introducing mechanisms for early intervention and preventive action to address fiscal risks before they become severe.
- Promoting Economic Convergence and Structural Reforms: Wide disparities exist among EU member states in terms of economic performance, competitiveness, and productivity. Efforts to promote convergence and structural reforms could include:

  - Encouraging investment in research, innovation, and education to boost productivity and competitiveness.
  - Enhancing labour market flexibility while ensuring social protections to improve employment rates and reduce unemployment.
  - Implementing structural reforms to remove barriers to business growth, increase market competition, and foster entrepreneurship.
- Strengthening Democratic Legitimacy and Accountability: EU economic governance should be more transparent, accountable, and inclusive. Some suggested measures include:
  - Enhancing the role of the European Parliament in economic decision-making processes.
  - Promoting citizen engagement and participation in EU economic governance through public consultations and increased transparency.
  - Strengthening the role of national parliaments in shaping EU economic policies and fostering closer cooperation between the EU institutions and member state governments.

It is important to note that these suggestions are not exhaustive, and the specific reforms required for EU economic governance may vary based on evolving circumstances and political consensus among member states. Comprehensive reform would likely require negotiations and agreements among EU member states, involving complex trade-offs and compromises.

Regarding the future of the European Semester will likely depend on how the EU addresses these concerns and adapts to changing circumstances. Possible avenues for improvement include:

- *Democratic legitimacy*: Ensuring a stronger involvement of national parliaments and the European Parliament in the decision-making process to enhance democratic accountability.
- *Flexible approach*: Allowing for more tailored and country-specific recommendations that consider the unique economic challenges and circumstances of each member state.
- *Balancing fiscal discipline with growth*: Emphasizing policies that promote economic growth and job creation while maintaining fiscal responsibility.
- *Inclusion of social indicators*: Expanding the scope of the European Semester to consider not only economic indicators but also social factors to ensure a more comprehensive evaluation of a country's performance.
- *Addressing regional disparities*: Addressing the disparities between different regions within member states, ensuring a more balanced distribution of economic opportunities and development.
- *Coordination with other EU policies*: better coordination with other EU policies and initiatives to create synergies and avoid conflicting measures.
- *Public engagement*: Encouraging more public debate and involvement in the European Semester process to increase transparency and legitimacy.

At the same time, however, it is necessary to realize that joint decision-making by European institutions and member states, or the parallel competences of the EU and its member states hinders the success of a common European position (Lütz, Leeg, Otto, Dreher, 2021). As Biscop (2019) reminds us, some governments not only violate EU values, but also actively undermine EU policies. It should be considered that the EU is facing a significant challenge today, as anti-EU populist parties are gaining strength in several member states. The most relevant political divide in Europe today is not between right and left, but between those who are turned inward and those who embrace further integration (Bradford, 2020). It is good to remember with Youngs (2021) the risk that more Europeanised policies or a single EU voice has not always produced better results.

IV. Conclusion

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), Czechia was not subject to an in-depth review to assess its vulnerabilities (European Commission, 2022). The 2023 Alert Mechanism Report (AMR) published in November 2022 concluded that an in-depth review (IDR) should be undertaken for Czechia this year, with a view to examine newly emerging vulnerabilities and their implications. The AMR concluded that in Czechia, concerns related to cost competitiveness and house price developments, which existed already before the COVID-19 pandemic, persist. Nominal unit labour costs are set to grow further, with an appreciation of the real effective exchange rate being underway and core inflation being very high compared to Czechia's euro area peers. Nominal house price growth has been amongst the highest in the EU, while house prices are estimated as being overvalued.

Czechia's post-pandemic recovery was impeded by surging inflation in 2022 and is expected to remain weak in 2023 (European Commission, 2023 e). In 2022, the Czech economy grew by 2.5 %, dampened by a worsening financial situation of households, slowing external demand and receding problems in global value chains. Economic activity is forecast to increase only moderately (0.2 %) in 2023 driven by exports but being held back by low consumption on the back of a decline in real disposable income, a tight financial situation of households, and rather low consumer sentiment. GDP growth is forecast to increase by 2.6 % in 2024 supported by recovering domestic demand and an improving economic situation in Czechia's main trade partners. Consumer price inflation (HICP) increased to 14.8 % in 2022 and peaked at 19.1 % in January 2023, driven by fast-growing prices for commodities and production inputs. Cost pressures are set to ease during 2023 on the back of a decline in real income and tight monetary policy, bringing inflation down to 11.9 % in 2023 and 3.4 % in 2024. More expansionary fiscal policy presents an upside risk to both the growth and the inflation forecast. If inflation expectations become unanchored and contribute to wage increases, inflation could exceed expectations. At the same time, downside risks could stem from a stronger than forecasted downturn in domestic consumer and investment demand. This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for Czechia. Vulnerabilities related to housing and competitiveness in Czechia are also discussed in horizontal thematic notes that were recently published (European Commission, 2023 f, g). The MIP assessment matrix was published in the 2023 Country Report for Czechia (European Commission, 2023 h).

The current discussion on economic governance reform in Czech professional circles is reduced to the problem of compliance with fiscal rules and their enforceability in the member countries of the European Union. In a broader framework, the problem of the compatibility of fiscal consolidation with the reassurance of green and digital transformation is connected. There is a complete lack of a broader perception of economic policy as a complex of measures not only in public but also private financial resources. It follows from the above that the issue of economic governance is very complex. Its individual components must be realized in mutual connection. It is not possible to take isolated measures. In contrast, the policy of the Czech government seems to lack this complexity.

Therefore, the issue of economic governance reforms should also be extended to measures in monetary policy which only reflects the inability to harmonize fiscal and monetary policy in the Czech environment. It is also necessary to develop a discussion about the entry of the Czech Republic into the banking union, entry into the Exchange Rate Mechanism II and to stop fearing the introduction of a common currency. The own currency was expected to protect the Czech economy from long-term high inflation, but this did not prove to be the case. Moreover, in the case of the introduction of the euro, investors would not have to face such high interest rates. Radek Špicar (2023), vice-president of the Union of Industry and Transport of the Czech Republic for economic policy and export, points to the loss of the comparative advantages of the Czech economy, such as a more qualified and cheaper workforce together with quality infrastructure. Also, the low tax burden is still an advantage, but we can get rid of it. In this situation, the government's economic policy must be more oriented towards the production of final products with high added value and their competitiveness on world markets. Subcontracted production will not increase the performance of the Czech economy at a sufficient pace, which is necessary for faster convergence. Given that the Czech economy is facing serious fiscal difficulties caused by insufficient growth, the absence of reforms and the wasteful management of public finances, it is necessary to create and implement a comprehensive package of measures that will help its accelerated transformation. It should be noted that the loss of competitiveness is not the only threat to the Czech economy. Even the European Union must respond effectively to challenges coming from overseas, whether it is the American Inflation Reduction Act enticing European investors to leave the Old Continent, or Chinese and Russian initiatives to penetrate new markets (such as the Chinese Belt and Road Initiative, or the Russia-Africa Economic and Humanitarian Forum). One example of the right response is the European Act on Critical Raw Materials, which aims to strengthen EU capacities in the field of critical raw materials at all stages of the value chain. The act seeks to increase our resilience by reducing dependencies, improving preparedness, and promoting supply chain sustainability and circularity raw materials at all stages of the value chain.

There are other areas where the Czech government should focus its efforts and implement the necessary measures in economic area (tax reforms, incentives for businesses, subsidies, and financial aid to specific sectors or regions), in educational and social welfare area (the government may allocate resources for education, offer social assistance, and implement policies to support vulnerable groups), in infrastructure and transportation (investments in infrastructure projects, public transportation improvements, and road network maintenance are common), in environmental area (initiatives to combat climate change, promote renewable energy sources, and protect natural resources) or in labour and employment area (regulations to address labour market issues, protect workers' rights, and support employment opportunities). Also, security and law enforcement measures to enhance national security, combat crime, and ensure public safety or foreign policy measures are needed.

An effectively implemented economic policy needs not only to consolidate public finances, but also to reform economic governance in a comprehensive manner regarding gradual falling behind competitors, and this is doubly true for Czechia.

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