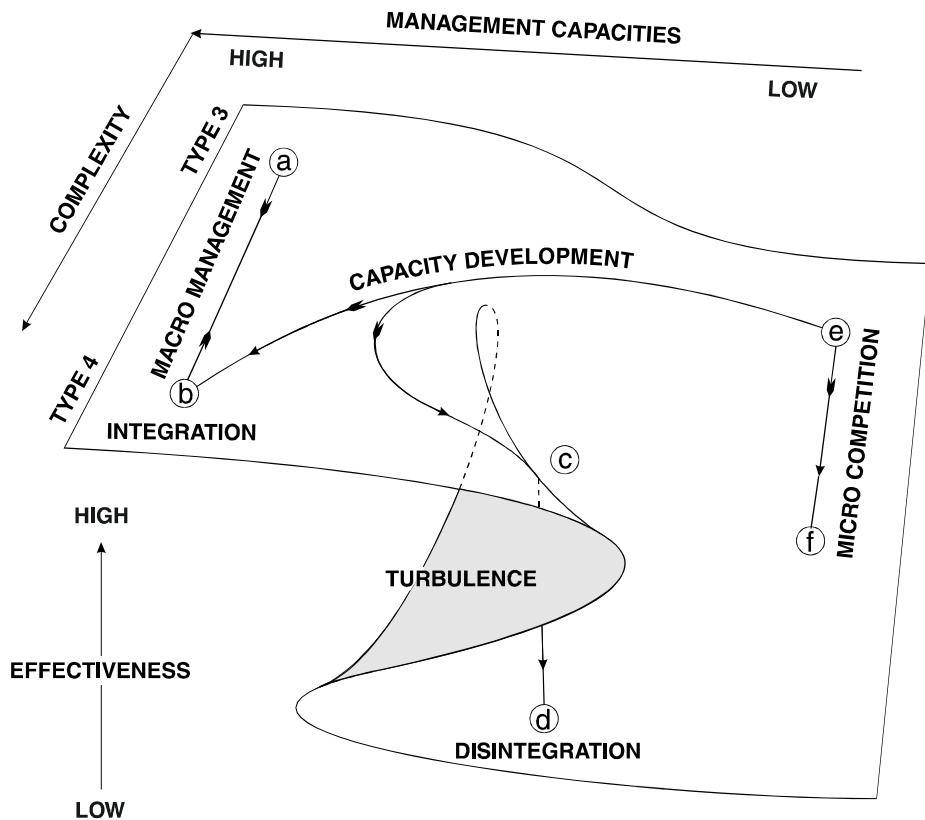


REFORMING THE EURO IN TURBULENT TIMES: MISSION IMPROBABLE

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DURHAM UNIVERSITY BUSINESS SCHOOL

Paper prepared for the 2011 International Congress of IIAS
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Introduction

The global financial crisis, triggered by the implosion of the US sub prime housing mortgage market and the collapse of Lehman Brothers in September 2008, has led to the deepest and most protracted economic recession since the Great Depression of the 1930s. Its depth and duration are still uncertain but its impact on economic performance, unemployment and public finances are already apparent (Stiglitz 2010). Whatever its long term effects, the Great Recession, as it is sometimes called, has exposed serious weaknesses in the system for managing the euro; the single currency shared by 17 of the EU's 27 member states and now the second most important reserve currency after the US dollar. The public finances of all euro zone countries have suffered severely as a result of the reckless behaviour of banks and the general deterioration of economic conditions as well as clear evidence of financial imprudence on the part of many governments.

The scale of the problems and the manifest difficulties of securing coordinated action to deal with them have prompted speculation about the break up of the euro zone. Rescue operations mounted in reaction to the crisis have not only seemed to be clumsy and ineffectual but have run into widespread public opposition. There have been violent political reactions in the recipient countries, such as Greece, because of the strings attached to financial assistance and the demands for austerity programmes. There has been vociferous public opposition to bailouts in countries expected to give financial assistance, notably Germany, but recently Finland, because of the heavy costs involved, the perceived unfairness of paying the bills for the profligacy of others and resistance to the idea of turning the eurozone into a "transfer union".

The threat of a full-blown global depression and meltdown of the financial system led eurozone governments to disregard breach the limits on public spending and borrowing enshrined in the Maastricht Treaty on Economic and Monetary Union (EMU) in an effort to boost demand. There is imminent danger of sovereign defaults by Greece, Ireland and Portugal despite persistent denials and despite the obvious reluctance of the so-called "core" countries to make firm commitments of help. To many observers it is not whether, but when, a default will occur.

Aside from the fumbling efforts to prevent an already deteriorating situation from getting worse it has become abundantly clear that the euro system was ill-prepared to recognise, let alone resolve, the problems that have arisen. But what kinds of reforms are needed to deal with the resulting turbulence? The question is an unwelcome, and for some, and unexpected one. Although in its first years the euro seemed to have a charmed life and was hailed as a successful innovation in the European integration process this assessment ignored a conjunction of favourable but fragile economic conditions. But optimism proved short lived. When the current crisis broke it was no surprise that the regime established by the Maastricht Treaty was inadequate to cope with it. Long before EMU was agreed there were serious doubts about the robustness of the euro regime. Economists argued that the initial participating economies did not constitute an Optimum Currency Area and many obstacles to cross-border trade and competition remained years after the supposed completion of the internal market. Political scientists were sceptical about the viability of a monetary union not backed up by political union with more extensive economic governance competences and some form of fiscal federalism. Subsequently, other deficiencies emerged that weakened the effectiveness and adaptability of the system.

In the struggle to cope with the impact of the Great Recession member governments and the EU institutions have committed themselves “to do whatever it takes to save the euro” and ensure the survival of monetary union. At the same time, it is clear that the existing system is not fit for purpose and reform is necessary. The crucial issue is whether a few additions and improvements to the current regime will be adequate to deal with future problems or whether more radical reforms are necessary. This begs the question “Fit for what purpose?” What shape should euro governance take in the future and what capacities are needed to make it work effectively?

There are, broadly speaking, two main kinds of reform strategy serving different purposes. One is a *consolidation strategy* to strengthen and reinforce the existing regime to make it more crisis-proof and better able to serve its original goals. The other is a *transformation strategy* aimed at designing and implementing a more appropriate and less crisis prone regime than the existing one. It will be argued that a consolidation strategy would prove inadequate because the existing regime is too narrowly based and lacks the governance capacities that will be needed to manage a much larger and more complex euro zone. A transformation strategy is a more difficult option but offers a better prospect of building a regime that can cope effectively with the challenges ahead.

Euro Reform: Mission Accomplished? Mission Impossible?

At the onset of the crisis there was little thought of a reform strategy. Emergency action was needed. But in the prevailing climate of confusion and uncertainty about the gravity of the situation it was difficult even to launch a coordinated rescue operation. The depth of the crisis was underestimated because of a lack of hard information and because policy makers deliberately played it down out of political embarrassment and a fear of causing a panic. National leaders continued to issue denials about the seriousness of fiscal problems affecting their own governments while taking unilateral crisis measures. At the European level there was a lack of coherent leadership. Reform seemed like mission impossible. Member governments were primarily concerned to protect their own national economic and financial

interests and despite the exhortations of the European Commission were reluctant to come together to address the crisis in a coordinated way. The independence of the ECB became more of a hindrance than a help in coordinating a crisis response. It had to cast aside its monetarist commitment to controlling inflation in the interests of ensuring that banking failures and governmental defaults did not choke off demand and drive the EU economy towards recession.

The various motives for denial and defensiveness that inhibited cooperation across the eurozone have gradually been exposed. The true depth of the crisis has become clearer as unpalatable truths about public finances and economic performance have surfaced. Despite this bleak prospect, in mid-April 2011, Olli Rehn, the European Commissioner for Economic and Monetary Affairs gave an up-beat assessment of the outlook for the euro to the Brookings Institution. Though he eschewed claiming “mission accomplished” he did suggest that the crisis management phase of saving the euro was nearly over and the EU was on the verge of major reforms of European economic governance. “The euro area will not only survive, but is coming out of the crisis stronger than before, once we have completed the ongoing reforms and built a new economic and financial architecture.” He went on to say that: - “We have identified the key systemic weaknesses of EU economic governance and are addressing them in a way that will profoundly change the policy-making landscape in the European Union.”

The first part of this prediction was rapidly overtaken by events as a new wave of speculation about the possibility of sovereign defaults engulfed the efforts to restructure and refinance the debts of the Greek, Irish and Portuguese governments. The second part is a long way from being realised. It is not obvious that the systemic weaknesses of the euro system are being addressed or even that they have been satisfactorily diagnosed. Nor is it clear what the longer term reform strategy will be. At least some progress has been made in creating the institutional means of dealing with and, hopefully, preventing future crises.

Although this is a rapidly changing picture at present it is possible to see a two stage strategy emerging. The first stage, expected to last until 2013, consists of interim measures to buy time, shore up the finances of governments seriously at risk of default; Greece, Ireland and Portugal; and prevent contagion to other vulnerable countries. This includes the creation of two sources of funding and support, the European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF), with combined resources of € 500 billion of resources. Financial assistance as a form of national humiliation is conditional on recipient governments taking severe austerity measures and introducing structural reforms of labour markets and pension systems.

Reforms of the euro regime itself are being treated with much greater circumspection. The core countries, especially Germany fear that any change might weaken commitments to price stability and fiscal discipline. The German government and the Bundesbank have been concerned to buttress the existing system and are under strong domestic pressures to limit the scope of reform to the absolute minimum. The lack of

a German candidate to succeed Jean-Claude Trichet as head of the ECB has heightened anxieties about a possible retreat from monetary orthodoxy.

Even so there has been some movement. At the EU level the position of the ECB has been strengthened somewhat so that it can give support to governments that have run into serious financial difficulties. But there is hostility to the extension of lender of last resort powers. This is an oddity because acting as lender of last resort is the key function of a fully fledged central bank. During the crisis the ECB has, in fact worked closely with the European Council, the Commission, Ecofin and the IMF as well as the national central banks. At the national level, governments in the eurozone and the wider euro system have participated on an intergovernmental rather than a supranational basis with worries about “beggar-my-neighbour” attitudes developing.

The second part from 2013 onwards has as its centrepiece the European Stability Mechanism (ESM). This is a permanent crisis management procedure which would open up the possibility of a lender of last resort function for the eurozone. It also includes a more rigorous programme of fiscal consolidation at the national level backed up by closer surveillance at the EU level and a more broadly based system of economic governance within a re-reformed Stability and Growth Pact (Mark 3). This will require much greater coordination among member governments and at the EU level than has been evident until now. Efforts are also being made to apply more rigorous stress tests to banks and tighten up bank supervision.

Up to a point it does not matter whether this is called consolidation or transformation. There is considerable scope for upgrading basic management capacities without getting to the point of deciding on a reform strategy. Like most of the EU the euro regime suffers from a “management deficit” and there is a lot of scope for basic improvement. However, the purpose of this paper is to look to the longer term reform issues and examine what needs to be done to ensure the euro system has the governance capacities needed to cope with an increasingly dynamic and potentially turbulent economic environment. It is not enough to repair and strengthen the existing regime. More radical reform is necessary to build the regulatory capacities to manage the eurozone in an increasingly complex and potentially turbulent environment?

Even if all of the current proposals come to fruition they will only give a temporary respite. The euro system has outgrown the assumptions on which the existing regime is based and without radical reform will remain vulnerable to crises. The system to be regulated is more extensive and more interdependent than the regulatory regime created by the Maastricht treaty can possibly cope with. A new governance framework is needed to manage, proactively, systemic problems that at present are dealt with in a reactive *ad hoc* way. Averting crises, rather than having crisis management arrangements on permanent standby, requires a thorough diagnosis of the systemic sources of the current turbulence in the euro zone and new institutions and policy processes for transformation the regime in the future.

A transformation strategy is needed because the Great Recession is not an isolated, one-off event. It is a forerunner of systemic problems that are likely to recur because of increased economic interdependence in the global economy. Further outbreaks of turbulence will do great damage to the functioning of the euro zone and the European

economy unless new governance capacities are developed to deal with them. A consolidation reform strategy will not do the job. The requisite governance capacities cannot be incorporated in, or bolted onto, the existing regime.

Before explaining the rationale for a transformation reform strategy and the form it might take the next section will briefly outline the main feature of the euro regime as established by the 1992 Maastricht Treaty. The subsequent section offers an organisational critique of the euro regime as it has functioned since its inception. In particular it notes the failures to heed warning signals and the inability to take corrective action even when problems were clearly identified.

THE ORGANISATION OF EMU

The main features and history of the euro regime established by the Maastricht Treaty on European Union (TEU) have been extensively described elsewhere (Eichengreen, 1998; MacNamara, 2005; Marsh, 2009; Tsoukalis, 2003). They include the creation of the European Central Bank, establishment of “convergence criteria” applying to government debt and deficit levels that were set up as conditions of membership, the negotiation of the Stability and Growth Pact as the policy doctrine underlying the operation of the system and the framework of European law-based control and accountability including heavy sanctions in the event of non-compliance by member governments.

The 1992 Treaty provided the legal framework defining the institutions the policies and goals and a programme for moving to Economic and Monetary Union (EMU) among the countries willing to do so. In fact the system established was much more a monetary than economic union. It relies heavily on monetary instruments and was imbued with a monetarist economic philosophy that gives overriding priority to controlling inflation and defines price stability as a precondition of economic growth.

The basis on which the system was designed had two guiding principles: stability and independence. In the first place, stability refers to the elimination of the exchange rate fluctuations among national currencies which had hampered the functioning of the single market. Removing this source of uncertainty and instability was expected to help create conditions for economic progress. Stability also figured prominently in the operation of the single currency. The priority policy objective for managing the euro was price stability. Targeting inflation was a key objective of the monetarist policy doctrine that informed the operation of the euro system from its inception. This was later incorporated in the Stability and Growth Pact. But it was always clear that stability had priority. Growth was expected to come as a consequence of maintaining a stable monetary environment.

Central bank independence was the institutional counterpart of the commitment to price stability. This was reflected in the establishment of the European Central Bank (ECB) as a supranational institution at the European level distinct from the core European institutions and with a narrowly defined mandate to guard against inflation. Its independence in conducting monetary policy was intended to enhance its credibility and lower inflationary expectations. The purpose of guaranteeing its independence was to insulate the ECB from political pressures to make concessions to

special interests leading to increased public spending, lax fiscal discipline and higher inflation. It protected the ECB from pressures from the national level by giving it a special status vis-à-vis national central banks within the euro zone and the EU as a whole. The model of the Bundesbank was often quoted and the point was reinforced symbolically by locating the ECB in Frankfurt. What has been less commented on is that the ECB is not a self contained isolated organisation. It is the apex of the European System of Central Banks and a central bankers' "epistemic community" (Haas, 1992). All national central banks participate in its policy formulation and decision-making processes as well as playing important roles in implementation. (See Jung, Mongelli and Moutot (2010) for an up to date insiders' account.)

The Maastricht treaty enshrined independence in another less obvious way. EMU set "convergence criteria" for fiscal policy that all participating national governments in the euro system were required to abide by. The convergence criteria defined the limits for government budgets and borrowing. The deficit and debt constraints that each government was expected to keep to were a maximum of 3% government deficit to GDP and 60% public debt to GDP. There was, quite deliberately, no bail out provision and no assumption that either the EU collectively or member states individually were responsible for each others' debts. Each member government was required to keep its own fiscal house in order. This was backed up by an EU control and accountability system included the possibility of draconian penalties for non-compliance after a series of warnings issued by the Commission.

The macroeconomic side of EMU is more intergovernmental in character in comparison with the firmly supranational monetary policy side. The main institutions are the European Commission and "EcoFin" the Economic and Financial Affairs configuration of the Council of Ministers. The membership here consists of the finance ministers of the EU member states and meetings are normally preceded by meetings of the euro group of ministers. As Hayes-Renshaw and Wallace (2006) put it, they are bound together by common interests in expenditure control and macroeconomic policy and common enemies their spending ministries and the financial markets in which they borrow.

THE MAASTRICHT MODEL IN PRACTICE

This section reviews the experience of monetary union over its first decade and identifies specific organisational and management weaknesses in the euro regime. The euro regime as embodied in the Maastricht model has at least four significant defects that not only reduce its effectiveness but also cast doubt on the value of a consolidation reform strategy.

The first weakness is the obverse of its main strength as a regulatory regime with predetermined priorities and instruments to administer uniform policies across the whole of the euro zone and insulated from political pressures. Its weakness lies in what it was precluded from doing. The limitations can best be seen by reference to Young's (1999) fourfold typology of regime functions: regulatory, programmatic, procedural and generative. Each function has different management requirements that are briefly described below.

Regulatory regimes are administrative means of setting common standards and securing feedback to monitor compliance with them. The Maastricht model was intended to just that. *Procedural regimes* are one step back in the policy cycle from the regulatory stage. The function of procedural regimes is to *establish practices* that enable the participants to deal with collective problems where existing rules need to be modified or new norms developed. *Programmatic regimes* are the international analogues of project management systems. They are temporary forms of collaboration among governments to achieve specific goals or serve particular purposes although, like the arrangements to launch the euro in 2001 they may be precursors of more firmly institutionalised regulatory and procedural regimes. *Generative regimes* play this transformational leadership role of formulating a "big idea" and mobilising the constituencies and coalitions to support change. A generative regime does not have a clearly defined task. Instead, its function is to structure ill-structured problems.

The Maastricht model is was quite deliberately designed to be a regulatory regime only, with as little policy discretion as possible. It is a regime without an inbuilt capacity to enable it to adapting to change. The monetary side of the system in particular is supposed to function solely as an operational management system. The absence of any regime competences other than regulatory competences has proved to be a serious handicap in dealing with the crisis. Crisis management arrangements have been distinctly *ad hoc* and have often seemed politically inept.

Within the regulatory regime itself, there is little doubt now that many of the member governments do not have adequate capacities to manage their finances, budgets and borrowing within the prescribed convergence limits. The Maastricht model placed very heavy reliance on these national level capacities and also assumed that they alone would almost suffice to keep public finances under control across the whole system. In this the architecture of the Maastricht regime approximates Herbert Simon's (1962) model of a nearly decomposable system; a model of organisation in which closely interdependent activities are contained within (national) subsystems and there is only weak residual interdependence between subsystems to deal with at higher (EU) levels. The attraction of this model is that if all subsystems are able to keep their own house in order systemic problems are unlikely to arise and therefore little coordination problems would be minimal.

Aside from the painfully obvious fact that most if not all member governments have shown that they are not up to the job, the assumption that the eurozone is a loosely coupled system in which there is little spillover is not borne out by experience. Moreover it is at odds with the idea of providing a framework for managing the increased interdependence associated with economic integration and at odds with the view of neofunctionalist theorists actively seeking spillover to increase the momentum of integration.

Third there are also deficiencies on the monetary policy side. The commitment to a one-size-fits-all monetary policy with interest rates set by the ECB was probably the most visible symbol of monetary union. The assumption was that the freer operation of market forces boosted by the policies of the Lisbon Process would have a harmonising effect and lead to the convergence of standards of industrial productivity and economic growth across the EU economy. But the unintended consequence of equalising interest rates was to allow some governments, businesses and consumers to

indulge in excessive borrowing and generate unsustainable asset bubbles. Some of the current political strains in the system are due to divergences in economic performance over the last decade rather than the hoped-for convergence. In addition, national governments now face more integrated bond markets where financial institutions can adopt divide and rule tactics and exert pressure for EU bailouts.

The fourth weakness is in the area of control and accountability. As noted above, the system was supposed to be almost self managing at the national level. But the Stability and Growth Pact did include provisions for surveillance at the EU level of national compliance with the budget and borrowing convergence criteria. However the operation of this system required investments in capacities for managing coordination that were wilfully ignored. It is instructive to use one of the systems archetypes devised by Peter Senge (1990) to diagnose the potentials and pathologies of organisational learning to explain how the system malfunctioned. Senge labelled the relevant systems archetype “fixes that fail”.

How does an organisation respond when there is a significant gap between actual and desired performance? The constructive response is to rise to the challenge and invest in the capacities needed to raise standards of performance. The soft option is to retreat into a political comfort zone and lower standards. Instead of investing in new capacities to raise performance standards expectations are lowered. On the grounds of realism and pragmatism expectations are lowered and aspirations are confined to muddling through. Fixes like this fail because they treat the uncomfortable symptoms of substandard performance but do not get to grips with the underlying problems. In the eurozone there were problems from the beginning. Some countries were so far away from meeting the convergence criteria that the standards were never seriously applied. Two founder members of the EU (EEC), Italy and Belgium, were the outstanding examples. Italy under Romano Prodi as prime minister worked hard to meet the budget limits but in a short time could not possibly reduce public indebtedness from over 100% to 60% of GDP. Euro membership was granted on the basis of a promise to try. No sanctions were invoked when they ceased to try.

Subsequently a number of countries including Ireland and Portugal exceeded the limits and were threatened with the prescribed sanctions if they did not mend their ways. Then more serious breaches occurred which called into question the integrity of the system. Germany and France went over the limits. Problems with Greece included not just failure to keep within the limits but clear evidence of deliberately misstating the government’s debt and deficit position in the presentation of statistics. As more and more failures came to light the Commission threatened and then initiated the procedures to apply sanctions and exact very large penalties. When the Council of Ministers defied the Commission the Commission took the case to the ECJ. The Court refused to rule and referred the matter back to the Council of Ministers. The fix that was eventually agreed on by the Council of Ministers was to lower the standards of the Stability and Growth Pact by rewriting the rules to bring them closer to current reality.

It is instructive to view this process of lowering standards by comparing the coordination capacities needed to manage in the Stability and Growth Pact with those that were actually deployed. The scale in the accompanying diagram provides a systematic way of assessing the deficits in capacities for managing coordination in

organisational networks where the constituent organisation work together rather than being subordinate to a central authority. This scale differentiates and inter-relates a set of organisational capacities for managing coordination (Metcalf 1994). Coordination is the means of managing interdependence. As represented in the diagram, capacities for managing coordination can be visualised as a series of steps. Each successive step makes a distinctive contribution to coordination and building on those below. The functioning of each successive level of capacity contributes something new to managing coordination but also depends on the operation of lower levels capacities. More difficult problems of coordination require the activation of higher-level coordination capacities. When lower levels function well they filter out simpler and uncontroversial coordination problems.

CAPACITIES FOR MANAGING COORDINATION

- 9. JOINT STRATEGY**
- 8. SETTING COMMON STANDARDS**
- 7. ARBITRATION OF CONFLICTS**
- 6. CONCILIATION (MEDIATION)**
- 5. SEARCH FOR AGREEMENT (CONSENSUS)**
- 4. AVOIDING DIVERGENCES (SPEAKING WITH ONE VOICE)**
- 3. CONSULTATION (FEEDBACK)**
- 2. EXCHANGE OF INFORMATION (COMMUNICATION)**
- 1. INDEPENDENT BUDGET MANAGEMENT BY INDIVIDUAL GOVERNMENTS**

According to the original design of the euro regime, the functioning of the fiscal policy component of monetary union relied very large on the budgetary management capacities of the member governments (level 1). The demands on the control and accountability system were expected to be limited, but in principle adherence to the common standards set by the convergence criteria required coordination capacities up to and including level 8 in the scale. As the brief account above has shown at various times there were multiple deficiencies at several levels of coordination. The ECJ failed to perform an arbitration role (Level 7) the Council of Ministers was unable to play a mediation role and had difficulty reaching a reliable consensus (Levels 6&5). Rather than maintain a united front in public, some national governments have made a point of asserting their independence (Level 4). Most recently in the case of Ireland it is rather clear that the information base of decision making was seriously deficient while the Greek government (with the collusion of Goldman Sachs) deliberately hid the extent of public borrowing from the Greek electorate and its European partners (Levels 2 & 3).

The whole structure of coordination is flawed and unreliable. A thorough overhaul is needed to prevent the system malfunctioning in the future. In any case, strengthening coordination is a vital element in a larger process of regime reform. Even a consolidation reform strategy would require a substantial investment in capacities for managing coordination. But the next section will argue that coordination has a much larger and more important role to play in a transformation strategy.

The Management Deficit: An Interorganisational Perspective

The euro zone's management deficit and its manifest difficulties in mounting a coherent response to the current crisis are not attributable solely to its own institutional peculiarities. The current crisis in the euro regime is an acute case of a chronic problem of inadequate management in the European Union as a whole. Most if not all EU policy fields suffer to a greater or lesser degree from management deficits. From the outset European integration has been geared to taking on more than it can deliver. Successive political initiatives have been launched with the tacit assumption that the capacities to implement them would materialise. But with more numerous and increasingly complex policy responsibilities this assumption has become untenable. There is much evidence that capacity building is not an automatic process, including the still unfinished "1992" programme to complete the internal market, the Lisbon Process with its unrealistic aim of transforming the EU economy during the past decade and the recent back-tracking on the Schengen agreement under the threat of a wave of immigrants from Libya and elsewhere in North Africa.

What explains this pervasive problem? A broader perspective is needed to account for the management deficit in the euro zone and elsewhere. Interorganisational analysis provides the tools for developing a diagnosis of the management deficit and formulating solutions. First, as this section will show, it explains why there are endemic problems of undermanagement in pluralistic systems based on organisational networks. Second, the following section explains the genesis of turbulence in organisational networks and, the steering capacities needed to manage potentially turbulent systems.

The crux of the management deficit problematique is the inadequate provision of capacities for managing organisational interdependence. Even if individual organisations are good at managing in-house tasks their performance will suffer if they pay insufficient attention to managing their networks of external relations with other organisations (Huxham, 1992). The interorganisational dimension has more impact on performance as networks increase in complexity and organisational activities become more closely interdependent. But the evolution of organisational networks towards greater complexity is not automatically accompanied by increases in capacities for managing interdependence.

Because of the dispersion of power and decision-making responsibilities, pluralistic systems are distinctive in the means they use to achieve coordination and ensure integration. In the absence of a central authority to provide direction and ensure coordination it is up to the constituent organisations to manage interdependence themselves. The primary means of coordination in pluralistic systems is negotiation and bargaining among the constituent organisations. The integration of the system depends on multilateral negotiation among organisations at the micro level and among representative and regulatory organisations within a governance framework at the macro level. Negotiations, rather than central authority, define the roles and responsibilities of the various organisations and set the terms on which they work together.

Thus, the effective functioning of pluralistic systems depends critically on substantial organisational investments in the technical expertise and negotiating skills necessary to reach joint agreements, to manage interorganisational coordination and to implement agreed policies. Interorganisational negotiations involve much more than striking bargains and doing deals. This method of making decisions relies on the capacity and willingness of the organisations concerned to devote top level management resources to negotiating joint policies with their counterparts in other organisations (Raiffa, Richardson and Metcalfe 2002). As empirical studies have shown, the great bulk of the effort that goes into negotiations is the preparatory work of “getting to the table”. What takes place at the negotiation table is the tip of the iceberg; a visible but small part of the whole process of managing interdependence.

Unfortunately, there is no guarantee that the investments in behind-the-scenes technical expertise and public commitment to the negotiating process will be made by the participating organisations. On the contrary, capacities for managing policy negotiations are often inadequate. Negotiators come to the table poorly prepared to present their own position or to understand those of other representatives. Moreover they often lack the authority to make commitments. At worst they are delegates with little discretion; forced to refer back and await further instructions from their principals; rather than representatives confidently presenting a well prepared case and able to deal directly with their counterparts at the negotiating table.

A further complication in managing negotiations is the need to strike a balance between cooperation and competition. Managing through negotiations combines an integrative process of *creating value* with a distributive process of *claiming value* (Lax and Sebenius, 1981). There is a tension between reaching joint decisions and cooperative agreements and determining the shares of the gains from joint action. The functioning of the system as a whole depends on how negotiators manage the trade off between them and whether they frame the payoffs in zero-sum or variable-sum terms.

Management deficits adversely affecting the performance of the system are more likely if negotiating strategies are dominated by a competitive dynamic directed towards distributive goals rather than a cooperative dynamic guided by integrative goals. Where this happens pluralistic systems are liable to be undermanaged and vulnerable to failures of coordination. The constituent organisations underestimate the extent of their interdependence and concentrate on protecting and pursuing organisational interests. Coordination is an institutional public good. There is a common interest in having well developed coordination capacities but weak incentives for organisations to contribute to building them (Ostrom 1990).

The unintended consequence of a shortfall in coordination capacities is that pluralistic systems are always prone to fragmentation as organisations and governments pursue their separate goals. The component organisations give priority to their own interests and take for granted the stability of the system as a whole rather than contributing to it. Centrifugal tendencies weaken coordination and adversely affect performance. But this only reinforces doubts about the integrity of the regime and the long term cohesion of the system. In an increasingly uncertain situation leaders perceive claiming value in the short term as offering more secure payoffs than investing in the governance capacities that can create value in the long term.

The process of disintegration does not continue unchecked if organisations play reasonably well-defined roles and work within the boundaries set by an established regime. Even if performance and productivity suffer because of inadequate coordination the stability of the system is not at risk so long as there is general acceptance of the governance framework which regulates competition and keeps conflicts within limits. Even so, the system as a whole tends to drift erratically in response to changing internal and external pressures rather than being able to steer a deliberate course. The price paid for undermanagement is substandard performance.

A pluralistic system can survive so long it only has to deal with incremental change that can be accommodated gradually by piecemeal adjustments within the established governance framework. In a classic pluralistic way the assumption is that big problems can be broken down into their components parts and dealt with step by step. But a regime with such limited capacities is ill-prepared to cope with structural change affecting the whole system and requiring simultaneous rather than sequential adaptation. Treating structural change as merely difficult incremental change is liable to provoke a crisis. There is always the danger that an undermanaged drifting system degenerates into an unmanageably turbulent system when it faces structural change.

Managing in a Turbulent Environment

It is now necessary to define more precisely what is meant by turbulence and explain why the regulation of a turbulent organisational environment calls for new forms of governance. Turbulence is a currently fashionable term that is widely and loosely used to refer to almost any kind of unexpected change or shock that policy makers have difficulty in dealing with. Journalistic usage, unpleasant experiences by airline passengers and publishers' marketing ploys have added to the confusion. For example, Alan Greenspan, the long-time chairman of the Federal Reserve, entitled his memoirs "The Age of Turbulence" (2007). But he subsequently admitted to Congress that he was shocked and baffled by the market turbulence that triggered the Great Recession that his own policies had helped create. If his free market theory had worked markets should have anticipated the problems and prompted corrective action.

Despite uncertainty about the definition of turbulence the general idea is that things are running out of control. There is no shortage of recent examples of unexpected and unwelcome events that have had extremely damaging consequences. They include the sudden collapse of apparently secure financial institutions like Lehman Brothers and the insurer AIG, the Gadarene rush in financial markets from manic behaviour to panic behaviour as asset bubbles burst, the fears of contagion, domino effects and chain reactions through global markets. There has also been the exposure of financial innovation as fraud, together with moral hazard dilemmas of collapsing banks that are deemed "too big to fail" and bankers who see no inconsistency between receiving government bailouts while paying enormous guaranteed bonuses. Nor should one forget the rating agencies that ducked their professional responsibilities to report the extreme vulnerability of highly leveraged businesses or overlook the regulatory authorities that turned a blind eye to looming dangers.

While it is tempting to focus on one or other of these phenomena, it is the combination of them that is symptomatic of turbulence. Turbulence is not simply another challenge in the business environment that can be met by developing a new

strategy. It is different in kind from the challenges encountered by individual organisations in business or in government. In the context of European governance it is useful to define it more precisely as a systemic breakdown resulting from failure to deal with structural change. A pluralistic system plunges from drift into turbulence when high levels of organisational interdependence create structural problems that cannot be resolved by organisations acting independently.

The tipping point is difficult to identify in advance because it takes a combination of initially unrelated developments to cause structural instability. Turbulence is a systemic problem in the strict sense that is not reducible the faults or defects of particular institutions within the system. (Though, of course, particular institutional failings play a part in creating the conditions for turbulence.) It stems from overwhelming increases in organisational interdependence that make it impossible for individual organisations to define a viable strategy.

In turbulent conditions vicious circles are established between organisations and their environments that are mutually disruptive and destabilising for the system as a whole. In turbulent conditions it becomes impossible for individual organisations to pursue a viable strategy because their own actions undermine the environmental conditions on which their performance depends and overload the available governance capacities. This perspective on turbulence was developed originally in organisation theory and subsequently imported in integration theory (Emery and Trist 1965; Haas 1976; Metcalfe 1974, 1996, 2000). In this context turbulence is defined by specific and exceptional features of the “the causal texture of the organisational environment”. In line with what has been said above the organisational environment consists of a network of organisations. Distinctions can be drawn among organisational networks of different degrees of complexity that generate environments with different causal textures and pose different management challenges. Broadly, the causal texture of an organisational environment is more stable and predictable when an organisational network is loosely coupled. The organisations are able to act more or less independently. The causal texture of the organisational environment is more dynamic, unpredictable and potentially turbulent when a network is tightly coupled and highly interdependent. Here, organisations must work more closely together. In order to apply this to governance reform in the euro zone the management implications need to be specified more precisely.

Four types of organisational environment arranged on a continuum from simple to complex, can be distinguished: 1) stable homogeneous; 2) stable differentiated; 3) disturbed reactive and 4) turbulent environments. Since the terminology may be unfamiliar it should be pointed out that there is a direct parallel between the first three types and well-known economics models of industrial organisation; perfect competition, imperfect competition and oligopoly. To perform effectively in networks of increasing complexity organisations need progressively more sophisticated management capacities. *Both* the performance of individual organisations *and* the effectiveness of a network as a whole depend on whether management capacities match the complexity of the environment.

In a homogeneous perfect market environment only operational management capacities are needed. By definition individual organisations are too small to affect the stability of the market environment. An imperfectly competitive, stable

differentiated environment allows scope for product differentiation. This gives a competitive advantage to organisations with tactical management capacities that enable them to locate and occupy favourable ecological niches. In keeping with standard assumptions, their actions improve their own performance and prospects but do not change the environment or influence its stability in any way.

The causal texture of a disturbed reactive environment in, for example, an oligopolistic industry or many public policy systems is characterised by instability. Individual organisations are big enough, relative to the size of the system, for their actions to make a significant difference to the environment. Successful organisations must have strategic management capacities to determine their own policies in the light of their expectations and conjectures about how others intend to act - in the knowledge that their rivals are doing the same. At this level of complexity organisations are not simply adapting to an exogenously given environment but by design or accident shape the environment for the future in conjunction with others. The causal texture of the organisational environment is continually modified by the strategic interaction of the constituent organisations. In oligopolistic and similar situations strategic behaviour takes place within a regulatory framework that sets the rules of the game but allows the players scope and discretion to compete and cooperate with each other. While rivalry among competing interests tends to dominate, disturbed reactive environments in business and politics are also characterised by overt or covert collaboration as strategic alliances, coalitions, joint ventures, consortia, cartels and partnerships are formed and dissolved.

The conventional economic logic of industrial concentration would have monopoly as the fourth model in the series after oligopoly. But organisation theory points in a different direction; towards institutional diversity rather than monopoly control. What is distinctive about the fourth type, the turbulent environment, is that; instead of a network composed of similar organisations in basically competitive relations; the network consists of linked sets of dissimilar organisations. There is a more elaborate organisational division of labour and different types of organisation are responsive to different values, incentives and modes of accountability. Organisational diversity has important implications for the stability and effectiveness of an organisational network. The functional and cultural differences among the organisations in a network cannot be eliminated. Different types of organisations have to work together but the rules of the game are often ill-defined, contradictory and poorly policed. This is strikingly different from oligopolistic industries and intergovernmental relations in a type 3 environment where mergers and acquisitions can increase organisational control and reduce competition while regulatory authorities can act to enforce the rules of the game.

The increase in organisational diversity adds a new order of complexity to the tasks of regulation because it shifts the emphasis very strongly from competitive to collaborative interdependence (Metcalf 1996). Different kinds of organisations have to understand each others' roles and responsibilities and establish reliable ways of working together. In a type 3 environment organisational similarity means that one organisation can readily understand what motivates another. And, at least in competitive market situations, mergers and acquisitions are possible. In a type 4 environment, irreducible organisational diversity is the new complicating factor. The underlying causes of turbulence are a combination of an expansion in the scope and

complexity of the organisational network and a failure to transform the governance structure to cope with the increase in complexity. The constituent organisations have to cope with a confusing and unstable mix of cooperative and competitive interdependence compounded by tangled contradictory sets of rules of the game.

Coordination across institutional and cultural boundaries is much more precarious. It is more important, but much more difficult, to ensure the priority of creating value over claiming value with such disparate interests in play.

The most obvious source of diversity in the euro zone is national differences. National traditions create institutional disparities that EU regimes have to encompass and integrate (Pollitt and Bouckaert, 2004). Member governments are expected to protect and advance national interests in international negotiations. But this can be problematical when there are cross-cutting business linkages. The German government has obstinately resisted demands for bailouts of troubled governments such as Greece and Portugal. But it is constrained by the fact that sovereign defaults could threaten heavy losses on money lent by German banks. The British government – although not in the eurozone – was quick to offer to contribute to the Irish bailout rather than have to deal with financial and political impact of heavy losses that British banks might otherwise suffer.

Other sets of organisations cut across national boundaries rather than following them. For example, there are long-standing working relationships among the set of national central banks which now work together within the ECB framework. Finance ministries and economics ministries form other distinct but less integrated organisation set. In the business sphere, banks and financial intermediaries operating in bond markets that lend to governments add to the diversity of the organisational ecology. Among these the increased importance of sovereign wealth funds from outside the euro zone and the EU cannot be ignored. It is also worth mentioning the ratings agencies, such as Standard and Poor, which despite their dubious past record have become influential players in the process of assessing the credit worthiness of governments.

Managing Turbulence in the Euro Zone

The transition from disturbed reactive to turbulent conditions has particular relevance to the current crisis in the euro zone. The existing euro regime is built largely on the assumption of a network of similar organisations operating within a stable regime that provides a common set of rules of the game and sufficient coordination to assure stability. But the evolution of the organisation environment has led to increased interdependence across an expanding network of more diverse organisations many of which operate outside the established regime and may be ideologically opposed to inclusion in it. Banks and other financial institutions are particularly wedded to the idea that they should be subject to minimal regulation.

The danger in this situation is that early signs of a systemic breakdown are misinterpreted and evoke crisis responses which trigger turbulence. Under the stress of a disintegrating situation organisations attempt to withdraw from external commitments and insulate themselves from environmental threats. But the aggregate effect of such self protective crisis responses is to provoke unproductive conflicts, weaken trust and precipitate systemic breakdown. Like the disintegrative dynamics of a prisoners’

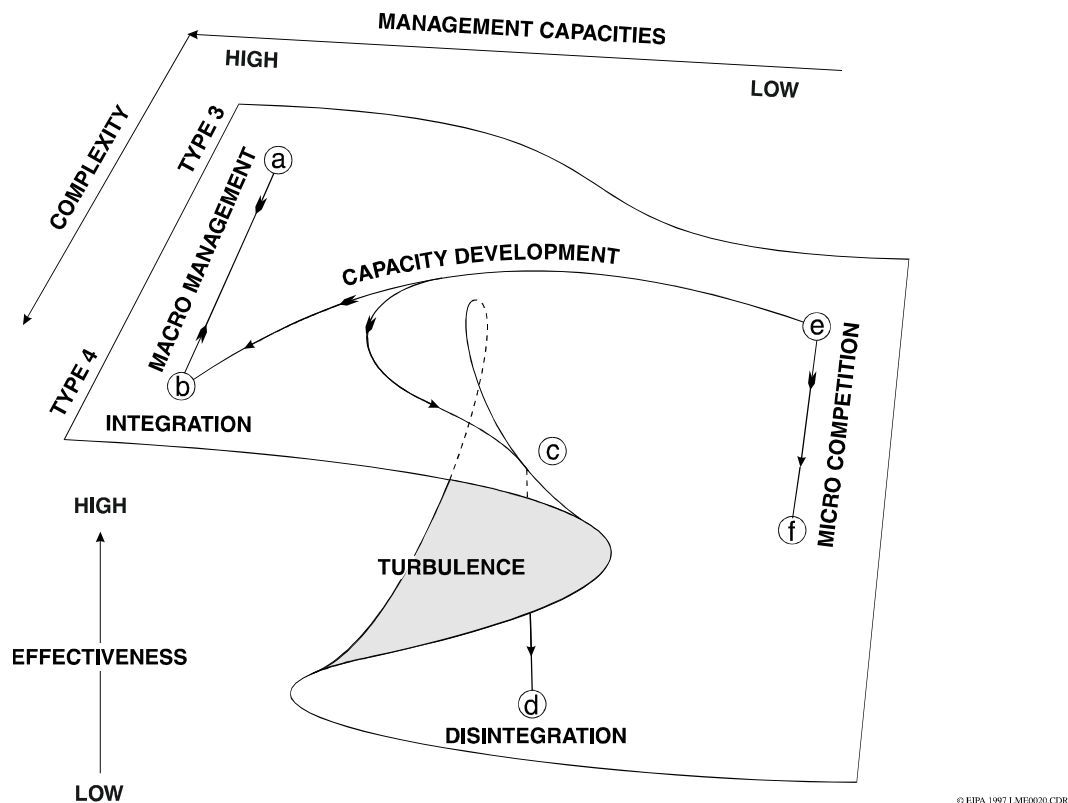
dilemma game or the maladaptive competitive behaviour of panic situations, individually rational organisational strategies combine to produce collectively irrational outcomes. There seems to be no way of preventing things from going from bad to worse. Interorganisational coordination suffers a catastrophic breakdown.

What can be done to prevent this degenerative process? There is an important clue in the diagnosis of turbulence sketched out above. The solution is not to be found in strengthening the management capacities of the constituent organisations. The problems cannot be solved by uncoordinated actions at the micro level. Nor can consolidation of the existing regime provide the requisite capacities. The problem to be solved is steering structural change rather than maintaining stability. The solution is to be found in the creation of new governance institutions and innovative methods of macro management. Insofar as there is a useful economic analogy for this process it is a macroeconomic model. Macroeconomic management (whether Keynesian or monetarist) is concerned with regulating the economy as a whole and dealing with systemic problems that are beyond the competence of organisations operating at the micro level. Turbulence, likewise, is a systemic problem and piecemeal attempts to deal with it at the micro level are liable to trigger the disintegrative dynamics they aim to prevent.

But the parallel with macroeconomics is an imperfect and somewhat misleading one. There are important differences in aims and method. First of all, in macroeconomic management the aim is stabilisation and making optimum use of the existing capacities of the economy. But the primary task here is adaptation and especially the management of structural change. In addition, macroeconomic management relies upon a central authority to make and manage policy. Great emphasis has been placed on the independence of the agencies involved – notably central bank independence. This is management of change on a grand scale but in the pluralistic context of the European Union it is not a task that can be handed over to a higher authority or to a group of independent experts. But steering structural change requires quite different methods because it is about managing interdependence through regimes based on “governance without government” i.e. a governance process that respects the pluralistic character of the system (Rosenau and Czempiel 1992). The macromanagement process must somehow resolve the conundrum of dealing with systemic problems without political union and a central authority.

The following diagram provides a way of visualising what is involved in dealing with structural instability. The general form of the problem and the type of solution needed to deal with it has been modelled by catastrophe theorists. They show how continuous incremental causes - in this case the growth of organisational interdependence - can produce sudden unexpected discontinuous effects as a critical threshold is reached. The onset of turbulence and the basic requirement for dealing with it can be represented as a ‘cusp catastrophe’. The diagram shows the effects on performance of both matches and mismatches between management capacities and environmental complexity in the transition from a type 3 to a type 4 environment.

Turbulence or Transformation?



The control factors are (i) capacities for collective action with the specific configuration of a macromanagement system and (ii) complexity levels around the threshold where structural problems are likely to occur. As the diagram shows the effectiveness of the response to structural problems depends critically on whether macromanagement capacities exist or can be developed to meet the challenge of structural change. If capacities already exist, they can be brought into use (a-b). If they do not exist a deliberate capacity building strategy is needed to ensure their development in advance of structural problems (e-b). If no capacity development efforts are made (e-f) or if responses are inadequate (e-c-d) the failure to match the discontinuity in the problems to be solved (from incremental to structural) with a step function change in management capacities (from micro to macro) will result in damaging disintegration rather than successful integration. The success of efforts to steer structural change depends crucially on macromanagement processes that facilitate joint efforts to design and develop new forms of governance.

Steering structural change requires relationships among the parties to negotiation that are the reverse of those employed in managing incremental change. Instead of attempting to build consensus around positions and interests defined initially at the micro level the key feature of a macro management process is that it requires a joint effort to arrive at a shared diagnosis of structural problems and to formulate solutions on the basis of an agreed view of future directions. The main emphasis, appropriately enough, is on integrative rather than distributive bargaining issues, centred on the design of new governance institutions and processes for determining policies and resolving conflicts.

It is important to add that the macromanagement process of steering transformation is not just the transposition of the normal interorganisational negotiation to a new arena. In significant respects macromanagement policy processes go against the grain of normal interorganisational (intergovernmental) negotiation. Cooperation at the macro level depends on the ability of leaders of representative organizations to unlearn old habits and work together in a different way. The process is still negotiation but the negotiating processes for transforming a regime are the reverse of those that serve to accomplish incremental change within an established regime. Instead of negotiators developing objectives and strategies from a micro perspective and treating the rest of the system as an environment in which to operate they must work together at the macro level to manage the environment in which micro activity takes place. Managing the environment in this context means transforming the regime to establish rules of the game that match the needs of a much changed and much more complex euro system. The challenge here is to define the macromanagement methods for steering the transformation to a new regime while respecting the pluralistic character of the system.

To begin with it is useful to have in mind Young's fourfold analysis of regime functions; generative, programmatic, procedural and regulatory. The existing euro regime was deliberately designed to play only a regulatory function and precluded from exercising the other functions. But in the present environment a transformation reform strategy should include all four functions. The macro management process to create a new regime would consist of four overlapping phases based on the four regime functions; the earlier stages preparing the way for those that follow.

The first phase is a generative process of diagnosing the problems to be solved and formulating reform options. The conduct of the process should start with the formation of a broadly based group that can consult widely and define the boundaries and stakeholders of the system. In a system where there are unresolved questions about the terms on which different sets of organisations work together it is important to ensure that all important elements in the network are included. The rationale for this is that a good regulatory regime must be based on a model of the system to be regulated and not a Procrustean view formulated by a narrow in-group.

The next stage would be creating a procedural framework to establish norms and guidelines for designing structures and agreeing policies. Again participation in the process is important both as a means of eliciting contributions and comments and also securing commitment to the design eventually agreed. This would be followed up by establishing a project team with a programme for developing the capacities needed to ensure the effective functioning of the new regime. Finally, the fourth phase of the transformation process would be the launch of a new regulatory regime could be launched and begin to frame and implement standard rules and common policies.

Conclusion: Mission Impossible

The main theme of this paper is that reform of the euro regime should be based on a transformation strategy rather than a consolidation strategy. The regime created by the Maastricht treaty is no longer fit for purpose and while consolidation reforms could correct some of its deficiencies they would not equip it with the governance capacities to

cope with a turbulent environment in the future. The regulatory regime as presently constituted lacks the capacities for dealing with systemic problems. This will expose the euro system to episodes of destructive turbulence in the future.

The extreme difficulty of managing turbulence arises from the fact that there is a sharp discontinuity between the micro level management capacities that serve the needs of individual organisations within a stable network and the macro level capacities that are essential to steering change at the level of a pluralistic network as a whole. A capacity building process is needed that enables pluralistic systems like the euro zone to make the step change from coping with the consequences of turbulence within an existing regime to managing regime transformation in order to prevent the emergence of turbulent conditions.

The process is analogous to macroeconomic management but the very important differences in function and process should not be ignored. The function of macromanagement in this context is not to maintain stability but to steer structural reorganisation. And, the process is a collaborative one that cannot be assigned to an independent institution insulated from political pressures. The political obstacles to such a major innovation as this are considerable. Relying on muddling through would make reform “mission impossible”. But instituting a macromanagement process of this kind calls for exceptional political leadership. Perhaps the best that can be said is that a macromanagement process of transforming the euro regime is mission improbable.

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