Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis

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The Euro in Uncharted Waters: *Cave, Hic Dragones!*

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The honeymoon period for the euro is over. It lasted for almost ten years, and some people had hoped it would last forever. They had hoped that the weak and unbalanced architecture of EMU, the product of political feasibility and economic orthodoxy prevailing at the time of Maastricht, would continue to defy the laws of gravity. Alas, the laws of gravity are now taking their revenge.

Underlying factors for the crisis

There are three basic underlying factors related to the ongoing crisis of the eurozone. The first has to do with the rapid rise in sovereign debt, which is largely, although not entirely, the result of governments trying to offset the effects of the bursting of the financial bubble. The second is growing imbalances between the North and the South inside the eurozone, while the third is about perception, widespread in Wall Street and the City of London and less so in many European countries, that Europe has neither the instruments nor the political will to deal with the problems that have arisen.

The dual problem of sovereign debt and internal imbalances is of course a real one to which financial markets typically over-reacted. Having underestimated risk for many years, and thus contributing massively to the creation of the bubble, they have more recently been seized by panic, and hence in search of safe havens. Financial markets are not very efficient, nor do they always behave in a rational fashion. There are also instances of market manipulation and cartel behaviour by big operators who try to turn bets into self-fulfilling prophesies. Social researchers could do some interesting work as to how established wisdom is formed and subsequently changed in an increasingly global market of information. The crisis of the euro would provide a very interesting case study. This said, the crisis of the euro is of course not simply, or even mainly, the work of speculators.

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Greece has been in the eye of the storm because it has the worst combination of three different kinds of deficits: a big budget deficit being added to an already large accumulated debt, an also big current account imbalance, as well as a credibility deficit which has resulted from the realization that Greek governments had been extremely economical with the truth (and with statistics). The Greek debt crisis has served as a catalyst for the broader crisis of the euro. But Greece has been increasingly perceived not only as a problem on its own (which it is), but also as a precursor of things to come in other countries and a test case of how others (and the EU collectively) may deal with growing sovereign debt and internal imbalances in the eurozone. Hence, domino theories have become popular again.

Existing mechanisms found wanting

The crisis has revealed major weaknesses in the governance of the eurozone, and the EU more generally: the ineffectiveness of financial regulation (a problem shared with most other countries of the developed world), the inadequacy of coordination procedures, big gaps in its surveillance mechanism, and the absence of a lender of last resort capacity. Some people had thought that the latter would not be needed, if the first three had worked properly, but this was really the triumph of hope over experience. The stability and growth pact proved inadequate from its very conception, it was further weakened in the process and never properly implemented.

The good news so far is that when they reach the edge of the precipice, European leaders finally react. The bad news is that Europe's crisis mechanism is woefully inadequate, the collective response is very slow, and the ensuing cost is high. Unanimity and compromise as the key operating instruments of European decision making, coupled with the progressive weakening of common institutions (at least as far as the Commission is concerned), do not make for efficient management of crises. In the case of the Greek debt crisis, there was noticeable lack of leadership. Admittedly, the crisis seemed to have confirmed all the worst fears long entertained in Germany about the euro – and when it came to the crunch only few were ready to argue the benefits. The role played by Germany is, and will remain, absolutely crucial.

The bail-out package for Greece – and the new European Financial Stability Facility even more so – would have been completely unthinkable only a few months ago. Those betting on the demise of the euro had clearly underestimated the commitment of members to the single currency –not for the first time. The stakes are indeed very high. Decisions so far have bought the Europeans some time; perhaps, not too long as markets remain unconvinced. As a consequence, the euro has continued to depreciate against the dollar and other currencies: a good thing for European competitiveness, although not enough on its own.

Catalyst for further integration

If crisis is indeed the mother of change, the crisis of the euro also proves to be a powerful catalyst for further integration. This applies to the governance of the eurozone in particular. We are likely to end up with a strengthened coordination mechanism for national fiscal policies, backed by a more effective surveillance mechanism and provisions for sanctions for those who do not obey the rules; stricter provisions and new institutions for the regulation of financial markets, coupled perhaps with the introduction of new taxes on banks and financial institutions; and with the ad hoc stabilisation mechanism taking eventually a more permanent form. But we are not there yet. The shape of European economic *gouvernement, governance* or S*teuerung*, is still in the negotiation stage – and usually, the devil lies with implementation even more so when collective discretion may be at least as important as common rules.

Those theoretically inclined could argue that further integration that is happening now as regards the management of the euro is a typical case of neo-functionalist integration. You start by integrating in one policy area, and this later creates the conditions (and the need) for deeper integration as well as for spill-over into other policy areas. Successive stages of dynamic disequilibria, if you prefer.

Today, further integration is the product of necessity. There is apparently little appetite for it, especially in the leading country, namely Germany. The result therefore is likely to be integration of a more intergovernmental nature, and this in turn raises some questions about the capacity of the system to deliver in the future. Experience suggests that intergovernmentalism has narrow limits. Inter-institutional relations in the EU are changing, and the current crisis could accelerate this change: the European Commission risks being the one that suffers most. On the other hand, the IMF has been given a key role in the implementation of stabilization programmes and the operation of new financial facilities, also contributing money of its own. Should this be regarded as a vote of no confidence for European institutions, or just a confirmation of European pragmatism?

Dangers lying ahead

We have not yet reached the final stage in the unfolding of the crisis that began with runs on banks and is now being followed by runs on states. The same is true of the new shape of European economic governance. There are difficult compromises that remain to be struck, many ambiguities that need to be clarified. And there are also big dangers that lie ahead.

Experience suggests that the strengthening of the coordination mechanism for national fiscal policies is something easier said than implemented. There is an old unresolved question about who (and how) sets the economic priorities for the eurozone as a whole. To put it differently: how will the burden of adjustment be distributed between deficit and surplus countries? This question goes many years back. The French have repeatedly tried, starting with the first plans for EMU and subsequently the EMS, to establish rules to ensure symmetry between surplus and deficit countries; with the benefit of hindsight, mostly in vain.

This in turn relates to the appropriate amount of fiscal Keynesianism (appropriate as defined by financial markets?) in times of recession and following the bursting of the bubble. Different answers may be traced back to history, ideology as well as different perceptions about the position of one's country in the European and/or global system. The French (and the European South) insist that fiscal consolidation in deficit countries should be accompanied by measures to bolster domestic demand in surplus ones. On the other hand, Germany, Finland and the Netherlands preach fiscal orthodoxy and stress the need to preserve competitiveness in global markets. The latter group seems to be winning the argument – or, is it simply a *bras de fer*? The crucial question though is whether there will be growth in Europe in the next months and years, and if so, how it will be distributed.

Greece as the weakest link of the euro-chain is faced with an enormous task of adjustment. The stabilization programme negotiated with (imposed by?) the European Commission, the ECB and the IMF is both extremely ambitious and painful. The government seems determined to stay the course and it still enjoys a margin of manoeuvre, largely due to the lack of any credible opposition in the parliament and the realization among an increasing number of Greeks that the alternatives would be much worse. But the political time it has at its disposal seems rather limited. The success of the stabilization programme will depend mainly on the speed and depth of structural reforms, the popular perception of fairness in the distribution of the burden of adjustment, and the articulation of a new narrative for Greece's development in the future that can both unite and inspire. Greece will be striving to avoid the deadly spiral of deepening recession and ever growing debt, which also constitutes a real threat for other European countries faced with the difficult task of fiscal consolidation in times of low growth.

Many European banks will need re-capitalization following rigorous stress tests which have been long delayed. Will this be a purely national operation? And how much regulation of banks and financial markets will we agree to have, also of what kind, including the distribution of responsibilities between the European and the national level? There is of course another kind of distribution at issue, which is politically very sensitive, namely the distribution of the cost of adjustment following the financial crisis between taxpayers and stakeholders in banks and financial institutions. It concerns individual countries and the EU as a whole.

Some people argue that we should also establish provisions for orderly restructuring of sovereign debt inside the eurozone, to prepare for such an eventuality, if and when it would arise, as a means of avoiding a systemic crisis. This would surely lead the euro boat into uncharted waters. If that were the case, one can only hope that careful navigation would be helped by more favourable weather conditions than the ones we have experienced in recent months.

If it is true that the crisis marks the end of an era for our countries and Europe as a whole, the reshaping of European economic governance may have to extend beyond the management of the euro in response to changing economic and social conditions, not to mention changes in the global order. The more ambitious ones talk about the need for a new political bargain at the European level, which would also include the strengthening of the internal market, concrete progress in terms of tax coordination, and measures to promote the transition to a low carbon economy. It is a tall order, while political will and leadership remain in short supply. The next few months are likely to be crucial for the future of the euro and European integration.