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We Need a New Grand Bargain in Europe

This article examines the linkages between economics and politics, markets and institutions during the most serious crisis that has hit Europe for decades. With the bursting of a big international financial bubble at its origin, it has exposed a systemic failure in the euro area coupled with different national failures. Many unthinkables have become reality since then at both, national and European level, but we are still nowhere near the end of the crisis. The distribution of the burden of adjustment within and between countries remains highly divisive, and so is the overall direction of the economic strategy: they are closely interconnected. EMU has become a make or break issue for European integration. Europe needs a new grand bargain to escape from the zero-sum mentality that has prevailed between creditors and debtors, between North and South.

1. European crisis and Russian dolls

We have seen many crises before. If anything, crises have been the catalyst for further integration during the last sixty years or so of Europe's revolutionary transformation from a continent with closed borders and a long history of wars to an ongoing experiment of ever increasing interdependence and shared sovereignty. The current crisis will once again lead to further integration, many seasoned observers of the European scene hasten to add, somewhat complacently. Others, however, are not fully convinced: they point to the magnitude and depth of the crisis in an unfavourable political environment and fear for the worst.[1] After all, this is the most serious crisis that has hit Europe for decades. Trying to understand its multiple dimensions and manifestations is like playing with Russian dolls: you take one, open it and find a smaller one inside, and so on. The trouble is that all those Russian dolls are pretty ugly.

The biggest financial bubble since the Great Depression burst in 2008. Private and public debt had been rising for many years, thus helping to preserve consumption levels in the West (and politicians in power) that were clearly unsustainable in the long run (Roubini/Mihm 2010; Hemerijck et al. 2009). Deregulated financial markets had grabbed an ever increasing share of the economic pie, while their operation resembled more and more that of a casino. And the international recycling of funds continued as long as China, the emerging economic power, remained stron-

1 Among others, see Krastev (2012), Lambsdorff (2012), Zielonka (2012) in the collection of essays published in the *Journal of Democracy* and also Garton Ash (2012) and Bergsten (2012) in *Foreign Affairs* with the characteristic title *Eurodämmerung* and *Is Europe Kaput?* on the front page. See also Moravscsik (2012).

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gly attached to its export-led growth model sustained by an undervalued currency. Inside the euro area, the role of China was played by Germany: large current account surpluses sustained by increased competitiveness in a fixed exchange rate system and recycling of savings to the rest. It was good for many, while it lasted.

What had begun as a financial crisis of the West, only indirectly affecting the rest of the world, turned into a European crisis during the last months of 2009, more specifically a crisis of the euro area, as people and markets began to realize what a currency without a state[2] really meant in difficult times. And Greece became the catalyst for this transformation, despite its relatively small size representing only about 2% of the output of the euro area. It did so because it had the worst combination of three different deficits, namely a large budget deficit, being added to an already huge public debt, an equally large, indeed unsustainable, deficit in its current account (a deficit of competitiveness, in other words), and a serious credibility deficit as people realized that Greek politicians had been repeatedly economical with the truth and creative with the use of statistics. At the time, many European leaders wanted to believe that Greece was unique. They have been gradually and painfully discovering ever since that – although Greece is surely different in many respects and arguably more difficult a problem to handle than other countries – it is also part of a much bigger and systemic problem Europe and the euro area in particular are facing (Tsoukalis 2012).

There is, of course, a debt overhang after the bursting of a big international bubble. In some countries, it mainly manifests itself as private debt; in others, it is mostly public. This is the biggest of Russian dolls, and it is international in its origin. There are high levels of indebtedness, public as well as private, in the United States, the UK and Japan; among the best of families in other words. The banking crisis and the sovereign debt crisis are two sides of the same coin. Most inconveniently, they feed into each other. Increasingly illiquid, or insolvent, banks have turned into a heavy burden for sovereigns that tried to save them and also save the real economy after the bursting of the bubble. In other places, such as Greece, it has worked the other way round.

Inside Europe, the crisis has taken a different – and much bigger – dimension because of the high levels of financial interdependence that extends beyond national boundaries and the existence of a currency union with weak institutions and instruments. In addition to the banking and sovereign debt problems, which are not unique to the euro area, there is also an internal competitiveness component which can no longer be dealt with through currency realignments. This is the euro doll: it has been at the centre of international attention in recent years. The signs of systemic failure are all too obvious. The surveillance mechanism set up at Maastricht has clearly not worked. The Stability and Growth Pact proved inadequate from its conception, and it was poorly implemented. If properly implemented the way it had been originally intended to, it might conceivably have prevented the Greek crisis. But

2 This very apt description of Europe's economic and monetary union was first used by Tommaso Padoa-Schioppa (2004), a leading European thinker and policy maker.

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it was surely not designed to deal with privately created bubbles, such as those experienced in Ireland and Spain. When the crisis struck, we all discovered (or were just reminded) that the European Union had no mechanism to deal with it – some had apparently been afraid of moral hazard. The Maastricht treaty had been the product of economic orthodoxy at the time of inception as well as political feasibility (Tsoukalis 2005; De Grauwe 2012). It now needs to adjust in times of severe crisis. Treaties are, after all, not written in stone – even less so, European treaties.

Inside the euro doll, there are many national dolls and some are uglier than others. Greece has been the precursor of the euro crisis, and it remains today a vulnerable link of the euro chain although not necessarily the biggest problem for the euro area as a whole. There are much bigger dolls that, once exposed more fully to the punishing attention of financial markets, could present a more systemic problem for the currency union because of their size. Greece's problem is the result of many years of mismanagement and clientele politics that had gotten out of control. No doubt the main responsibility for the derailment of Greek public finances and the steady loss of competitiveness during the period of euro membership lies with those who governed the country and indirectly with those who entrusted them with their votes (and who may also have been engaged in the party while it was on) – in other words, with Greek society in general, albeit a society with large inequalities and differences (Triandafyllidou et al. 2013). But if we are to engage in a blame game, the blame is surely not confined to Greek politicians and their voters. At least part of the responsibility also lies with EU institutions and Greece's European partners.

There have been other national failures too, with huge consequences for the countries concerned and the euro area as a whole. In Ireland, politicians had allowed a small number of bankers to bankrupt the Irish economy. The distribution of the burden of adjustment among taxpayers in Ireland, those joining the long queues of unemployed or others leaving the country in search of employment overseas, and creditors many of whom are other European banks remains a sensitive issue. A similar thing later happened in Cyprus, but there it is uninsured depositors in local banks that have been asked to pay a large part of the bill, perhaps because many of them are Russians. There is also a big Spanish bubble that has burst, and we are now learning more about the role of Spanish politicians, regulators and others in it. And there is more: recent revelations about mismanagement in the oldest Italian bank, *Monte dei Paschi di Siena*, tell a similar story. Given the chance, we may also become wiser about other countries and banks in the near future. One suspects that there are other dolls (and skeletons) that are hidden. Most German politicians, unlike their Anglo-American counterparts, had not acted as missionaries for deregulated financial markets when it was politically correct and fashionable to do so. But had they realized that their own banks had become an integral and indeed key part of the big international bubble while recycling the surpluses accumulated in Germany?

There have been colossal failures in markets and institutions all around. And there has been an economic paradigm behind the bubble, a paradigm that spoke of ef-

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ficient markets and rational actors armed with perfect information.[3] Now that the bubble has burst, we are paying a huge price in terms of lost output and jobs, and much more. The distribution of gains and losses from the bubble and its subsequent bursting has been very uneven within countries and even between countries. This is another reason for the growing unhappiness in many of our societies.

This article does not have major theoretical aspirations. It is broad in scope, trying to highlight the complex interconnections between international financial markets, European institutions and national politics. Of course, given the limitations of space, it cannot go into much depth with respect to any of them. It is a price consciously being paid. The main aim is to contribute to a better understanding of a multifaceted crisis, the linkages between economics and politics, markets and institutions at different levels of governance. The article has a strong policy orientation, with a short section in the end containing the broad outlines of a new grand bargain to steer Europe out of the crisis. It is thus normative in part.

2. *Crisis, the mother of change*

Many things have happened since the crisis hit, and in a big way. Crisis is the mother of change, helping to transform the unthinkable into reality. One way of presenting what has happened during the last three years or so is that economics and markets dictate and politics denies – or, to put it more precisely, politics tries to resist; with limited success though. It usually only succeeds in delaying unpopular decisions. Many such decisions have been taken, and policy measures have been implemented, that had been completely off the radar screen of politicians before the crisis hit. They belong to the long list of erstwhile *unthinkables* that have happened.

Policy measures have included fiscal consolidation in the deficit countries of a size that any sober policy maker would have considered politically impossible only a few years ago. If we take the example of Greece, which started from the worst position, the reduction of public deficit represents 9 per cent of a rapidly declining GDP between 2010 and 2012. This is more than any OECD country has achieved for several decades. Fiscal consolidation has been accompanied by structural reforms (in countries such as Ireland bold and fast, in others more or less slow and reluctant), which represent a radical departure from established patterns. Those changes, many admittedly long overdue, have been imposed through a combination of market pressure and political pressure: market pressure was exerted mainly through the rise in spreads on interest rates for government bonds, while political pressure came from euro partners and EU institutions, but also from the International Monetary Fund (IMF). The latter became directly involved through its participation in the so-called *troika* charged with monitoring adjustment programmes in individual member countries of the euro area.

3 Sargent/Wallace (1976) were among the pioneers.

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Those changes have been stress testing the political systems of the countries concerned, their economy as well as their social cohesion. Government parties in Greece, Ireland and Spain have experienced a crash in electoral support with no precedent for decades, while anti-systemic parties have been gaining strength in Italy and other countries. Unemployment has reached heights that had not been seen for very long and nobody expected to see them again during peacetime: unemployment rates in Greece and Spain have been above 25% for some time, and still rising.

At the European level, the list of things that have happened is also very long and indeed impressive. It includes sovereign bail-outs that dare not speak their name because they were not supposed to happen, with more and more countries joining the euro emergency room; the »voluntary« restructuring of Greek debt with the active participation of Greece's euro partners; huge refinancing of private banks through the European Central Bank (ECB) and direct purchases of sovereign bonds in secondary markets that may reach a yet bigger scale in the future; binding coordination procedures of national fiscal and economic policies that will take the joint management of European interdependence into new and uncharted territory; and big European firewalls, notably the European Financial Stability Facility (EFSF) followed by the European Stability Mechanism (ESM), that were not supposed to be there because of the fear of moral hazard. There are large amounts of money involved, a multiple of annual EU budgets. Furthermore, some of the measures mentioned above have required limited treaty change, and there could be more in the years to come. Most observers of the European scene had earlier reached the conclusion that the experience with the Lisbon treaty had destroyed any appetite for further treaty reform for a long time (Dinan 2011). In a period of crisis, long time may not last more than one or two years.

National and EU measures have invariably come late; they have been poorly implemented and even more poorly supported by governments directly concerned and a highly decentralized European political system (Bastasin 2012). The combination of widening economic divergence between countries and rising populism within them does not create fertile ground for European solidarity to grow. In the meantime, an increasing number of critics have begun to suspect (and argue) that the overall strategy is flawed.[4]

Yet, we may choose to see the glass half full, instead of half empty. When the crisis hit the euro area, there were many people who thought that Europe had neither the instruments nor the political will to deal with it. And some were ready to bet on the demise of the euro, and even the EU, more so in Wall Street and the City of London than in other places. Was it rational expectations, pecuniary interest, wishful thinking, or some combination of all three? They have not won their bet, although the game is not over yet. Throughout the history of European integration,

4 The literature is huge and fast growing. For a few, representative examples of a wide diversity of views on ways to deal with the crisis of the euro area, see Corsetti (2012); Cline/Wolff (2012); Darvas et al. (2011); Pisani-Ferry (2011), and Sarrazin (2012).

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there have been people who have consistently failed to recognize its political importance and the commitment of the parties involved. This commitment has been tested several times, and it has usually come out with flying colours. Now, the test seems harder than ever before.

3. *A broader picture*

The crisis of the euro has tended to monopolize interest and attention, thus turning the sub-system of the euro area into the core of EU activity. This is unlikely to change any time soon, and it is therefore bound to have broader consequences for the European political system as a whole. Economic and Monetary Union (EMU) is, undoubtedly, the most advanced form of integration, and the decision of some countries to stay out, combined with the inability of others to meet the criteria for accession, has created a two-tier system of membership of the EU – enhanced cooperation is a more neutral term to describe the reality of *ins* and *outs*.

The crisis is now forcing the *ins*, reluctantly or otherwise, to take further big steps in integration in order to strengthen the currency union. Surely, nobody is keen on joining in the midst of the crisis. But the majority of countries outside the euro want to keep the door open, knowing full well that otherwise they risk ending up as second class members in a more integrated European system. A minority, the UK most notably, refuse to even entertain such a possibility. The British Prime Minister has announced his intention to renegotiate parts of the UK's membership to the EU and call for a referendum in 2017 to pronounce on the result of this negotiation, thus leaving open the possibility of a UK withdrawal. Thus, while the majority of EU members are moving fast, by necessity mostly not by choice, towards further integration, one country at least is moving in exactly the opposite direction. Such tendencies, if sustained, will prove difficult to contain in the next few years. *Two-speed-* and *variable-geometry*-models will be stretched to their limit.[5]

Before the crisis, the EU had become increasingly identified with economic liberalization, hence running the risk of being delegitimized in the eyes of those who found themselves on the losing side of economic change. Parties of the centre-left in several European countries had become very much aware of this problem. With the crisis, perceptions have changed. In the North, the spectre of a European *transfer union* is haunting people:[6] the bail-out of the bankrupt economies of some of their partners requires ever increasing amounts of financial assistance and guarantees provided by Germany, Austria, the Netherlands and Finland among others; and their citizens (and taxpayers) are manifestly unhappy, especially since the benefits accruing to them through participation in the euro have not been adequately explained by national politicians. On the receiving end of guarantees and transfers, which

5 This literature goes many years back. For a recent, well-argued work on the need for a *two-speed*-Europe, see Piris (2012).

6 For a forcefully argued case along those lines, see Sinn (2012).

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are in effect interest bearing loans as long as they are being serviced, there are people who go through a long and painful process of budgetary consolidation, coupled with monetary squeeze, and who increasingly perceive the EU as the policeman of austerity and externally imposed change, or simply as a convenient scapegoat. European integration as a convergence machine is no longer working. The combination of the spectre of transfer union for some and the policeman of austerity for others has turned the European project into a zero- or even negative-sum game in the eyes of an ever increasing number of citizens. This can be politically explosive: Euro-scepticism has been rising.

Although almost all agree that over-indebtedness has been a key factor behind the outbreak of the crisis, the way deleveraging in the public and private sector takes place is crucial. No doubt, fiscal consolidation is required in many EU countries and further afield. Ageing populations, rapidly rising health care costs and a large increase in sovereign debt resulting from efforts to deal with the consequences of the crisis do not leave governments with much of a choice. Yet, if several countries resort to fiscal contraction simultaneously while the private sector is trying to reduce its debt exposure, the probability of ending up in a vicious circle of austerity and recession is very high. This is precisely where much of Europe's periphery and beyond (after all, the recession has spread to most European economies) finds itself today under tight fiscal and monetary conditions. Fiscal consolidation in a liquidity trap can be self-defeating, as Keynes had pointed out many years back. Rather belatedly, the IMF (2012) has discovered that the so-called fiscal multipliers are much bigger than originally expected. The overall strategy adopted to deal with the crisis carries a big economic cost, with broader political and social consequences for those countries worst hit by the crisis. Output lost today cannot be easily regained tomorrow. The unemployed become long-term unemployed, while some of the best brains and the most mobile in the labour force leave countries with high unemployment – and many will never return. Economies implode and the risk of social explosion rises. Of course, there is the opposite argument emphasizing the costs of delaying painful decisions: adjustment is inevitable, and the quicker it happens, the better, thus goes the argument that is, of course, more popular in creditor countries.

The bursting of financial bubbles leaves behind a debt overhang. History teaches us that some of it is usually written off, and some is eaten away by inflation (Reinhart/Rogoff 2009). The sooner the line is drawn between debt (private or public) that is sustainable and debt that is not, the quicker economic recovery will follow. Debt sustainability for some sovereigns remains the elephant in the room. There has already been a *voluntary* restructuring of Greek public debt, thus breaking a big taboo. It came rather late, and it may not be the last one for Greece or other heavily indebted countries, despite official protestations to the contrary. Of course, debt sustainability depends largely on growth prospects, and for the time being they are bleak for Europe as a whole. The restructuring and recapitalization of banks is also a necessary pre-condition for recovery. The moment of truth has been unduly delayed in Europe, unlike the United States, largely because of the large discrepancy

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between financial interdependence crossing national borders and the slow and cumbersome decision making system in Europe.

Not surprisingly, there have been huge difficulties in reaching an agreement about how to distribute the burden of adjustment within and between countries in the transition to a post-bubble world. Distributional issues are always politically sensitive, even more so when they are not confined within national boundaries. It remains true of the EU – and this time, the amounts of money involved are potentially very large indeed. Another way of presenting the distributional problem is with reference to surplus and deficit countries in a system of irrevocably fixed exchange rates. When there are no rules, the will of those with stronger staying power is likely to prevail. And these are usually the surplus countries. The economic effects of such an uneven distribution of the burden of adjustment between surplus and deficit countries are again deflationary.

The crisis has changed the balance of power inside the euro area and the EU as whole. Germany has emerged, beyond any doubt, as the indispensable country inside the euro area, the lender of last resort in many ways (Paterson 2011, Guérot/Leonard 2011). Thus, much of the politics of choosing the way to go about dealing with the crisis has been played out in Berlin. German political leaders have struggled to keep their French counterparts along with them. The Franco-German leadership will be tested as economic differences between the two countries grow and so do their respective perceptions and policy preferences, especially after the election of President Hollande in France. Finding a working compromise between the two countries will be absolutely crucial for the survival of the euro.

The German government was apparently not ready for such a leadership role. Leadership, like greatness in the words that Shakespeare put in Malvolio's mouth, was thrust upon it – and it was not at all sure what to make of it. The learning process has been slow and costly. Admittedly, the size of the problem is big, the reality shock rather strong, and internal opposition to costly European measures even stronger. But the stakes are also very high. What is the price that Germany is willing to pay to save the euro, and can the German government reconcile external expectations and pressures with domestic sensitivities? It is not, however, the only one faced with an extremely difficult predicament. How much adjustment are countries in the European South willing or able to make in a short space of time? Their respective governments have been finding out the hard way, and in the process many local politicians have been sacrificed on the altar of fiscal adjustment and reform. Europe needs answers to those questions that are consistent with each other. If they are not, another awkward question may follow, namely about who stands to lose the most from an eventual disintegration.

The German example of sound public finances, wage moderation and structural reform should be imitated by other countries – but only up to a point. What may be good medicine in the long term and under normal conditions risks killing a weak

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patient, especially when applied in large doses.[7] And there is surely a flaw with the argument that everybody should do like the Germans: if we all strive for current account surpluses, countries outside the euro area will have to provide the corresponding deficits. The United States are unlikely to accommodate. Do we think we have a better chance with China?

The crisis has generated a lively European debate about what needs to be done, which is much more than the usual juxtaposition of national debates. Germans are not just pitted against Greeks or Italians, *hard working Northerners* against *lazy Southerners*. Alliances are also being formed across national borders. There are trade-offs between taxpayers and bank stakeholders, between those with safe and well paid jobs and others joining the ever longer queues of unemployed in Europe. Not surprisingly, this increasingly European debate has been all-inclusive, from the populist variety often degenerating into nasty exchanges of national stereotypes to well informed exchanges among economists and practitioners, and the more or less visionary speeches of a few political leaders who sometimes dare cross the threshold of the pedantic. There have been many more manifestations of a European public forum as a result of the crisis, and this is surely a very good thing for European integration.

4. The challenge ahead

With the crisis, EMU has become a make or break issue for Europe. We have clearly reached a new integration frontier, and we are not at all sure what lies ahead. Europe needs to restore confidence in the irreversibility of its currency union, and to do that it must tackle first a dual problem: the fear of moral hazard prevalent in creditor countries on the one hand, meaning that, without adequate reforms and fiscal adjustment, money lent to countries in difficulty may go into a bottomless pit, and the convertibility (or country) risk on the other, a risk translated into capital flight and interest rate premiums for the indebted countries fed by self sustaining market perceptions and leading in turn to the fragmentation of the banking and financial sector in Europe across national borders.

Greeks, Spaniards, Italians and others (including the French) need to take full ownership of a wide ranging programme of reforms. And they need leaders of their own to articulate such a programme; it cannot be imposed from the outside, from Brussels or Berlin. But national politics retains a high degree of autonomy; it does not simply adjust to the dictates of European institutions or international financial markets. The tension between domestic politics and European/international economic interdependence has increased, sometimes dramatically during the crisis. And this is true of debtor as well as of creditor countries in Europe.

7 It is perhaps fair to say that many German economists form a school of their own. See, for example, Sinn (2012) and the open letter signed by 172 German economists and published in *Frankfurter Allgemeine Zeitung* (2012).

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Domestic ownership of reforms is a necessary but not sufficient condition for coming out of the crisis. Debtor countries going through a painful period of adjustment need time, money and an external environment that is more propitious to growth. Europe can provide all three as part of a new grand bargain that will take regional integration to a new stage, with firm commitments and conditions attached for all parties concerned. In designing the new grand bargain for Europe, the role of Germany will be absolutely crucial.

Fiscal consolidation and structural reform are a must, but the pace and sequencing need to be revisited. Bail-out programmes should be re-examined in the light of an ever deepening recession. There needs to be more emphasis on growth, and the quick recapitalization of banks, following restructuring where necessary, is an important pre-condition. Debt sustainability is also still an open question. More and painful decisions are required. The longer we wait, the higher the cost and the bigger the pain.

A distinction needs to be drawn between democratically regulated markets and market driven democracies. Before the latest financial crisis broke out, we had come very close to the latter. This is dangerous both for democracy and economic stability. Given the globalized nature of the financial sector, the effectiveness of regulation, supervision and taxation will depend largely on the will and capacity to coordinate those functions at international and European level. But waiting for all tax havens and offshore centres to agree should no longer be used as an excuse for doing nothing. The decision of several countries of the euro area to introduce an international financial transactions tax, the so-called Tobin tax, is a good example. In the days when there was more optimism about the European project, leading by example was meant to be a key element of the overall strategy.

Despite continuing differences on the specifics, there is growing consensus that the survival of the euro requires a banking union, a more advanced stage of fiscal (and economic) union including close and effective coordination of national policies coupled with partial and gradual mutualisation of debt, as well as further progress towards political union. Of course, the devil lies not only in the detail but also in the way decisions taken in Brussels are implemented (or not) at national level. Politicians (and lesser mortals) tend to leave difficult decisions for later and for others: *God give me virtue, but not yet*.

Perhaps, it also boils down to lack of trust: we are reluctant to deliver our side of the bargain because we are not sure that others will do the same. But the stakes are high and time is running out. Piecemeal or half measures prolong the crisis and make exiting from it more costly. The key challenge today is about restoring confidence in the capacity of our institutions, national as well as European, to take control of a very difficult situation. It is also about restoring trust between countries and regaining the conviction that there are benefits for all in our common European project.[8]

8 On 22 February 2013, German Federal President Gauck spoke of a crisis of confidence in Europe as a political project, while calling for more Europe.

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