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# No Exit from the Euro-Rescuing Trap?

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## Abstract

This paper attempts a normative assessment of the input and output-oriented legitimacy of the present euro-rescuing regime on the basis of policy analyses examining the causes of present crises, the available policy options and the impact of the policies actually chosen. Concluding that the regime lacks input-oriented legitimacy and that its claim to output-oriented legitimacy is ambivalent at best, the paper explores potential—majoritarian or unilateral—exits from the present institutional constellation that is characterized by the synthesis of a non-democratic expertocracy and an extremely asymmetric intergovernmental bargaining system.

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## 1 Prologue: My Many Debts to Gerhard Lehbruch

Gerhard Lehbruch was my guide when I moved from a habilitation fellowship in comparative constitutional law to an appointment in political science at the University of Konstanz in 1968. His “*Einführung in die Politikwissenschaft*” (1967) taught me to appreciate the topical breadth, the historical depth and the theoretical and methodological challenges of a field which, until then, I had only observed from the heights of constitutional doctrine and from the lows of election campaigns and intra-party battles. And though I never managed to become a proper political scientist, my policy-oriented research interests often intersected with Gerhard’s politics-oriented perspective in a polity-oriented focus on the same political institutions. Thus in the mid-1970s, we separately defined two basic problems of German federalism—where his focus was on the tension between party-political competition and intergovernmental cooperation and mine on the problem-solving

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deficits of the “joint-decision trap”. And when I tried to explain the successes and failures of social-democratic policies in the 1970s and early 1980s, I relied heavily on Lehbruch’s and Schmitter’s analyses of neo-corporatist interest intermediation. More indirectly, my theoretical perspective on European policy-making was also influenced by Lehbruch’s conceptualization of decision processes in consociational democracies. And even though my recent preoccupation with the political economy of the euro crisis seems far removed from Gerhard’s professional concerns, the concluding section of the present article was in fact inspired by a close re-reading of his 1991 review of the status of “*Das konkordanzdemokratische Modell in der vergleichenden Analyse politischer Systeme*”.<sup>1</sup> There, in an uncharacteristic turn to game theory, he modeled the emergence of consociational regimes as the outcome of an iterated Prisoners’ Dilemma—which also suggested that they remained vulnerable to the temptations of unilateral action. It was this reminder of the inherent instability of interest-based negotiation systems which encouraged me to speculate about exit options from the present euro-rescuing regime.

By way of disclosure: I love the coming-together of the peoples of Europe as much as anybody. But unity, peace and free mobility in Europe might also have been obtained in a Europe united under Napoleon, or perhaps even under Hitler’s successors.<sup>2</sup> In my own array of political values, however, integration per se will not override all concern for achievements of democratic self-government that have been realized in European nation states after Napoleon and after Hitler. At present, these are being jeopardized by the European regime that was established to deal with the economic and financial crises generated by an ill-designed European Monetary Union. The present essay will combine an assessment of legitimacy problems with problem-oriented and interaction-oriented policy analyses and with the exploration of potential exits from the present euro-rescuing trap.

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## 2 The End of Legitimacy Intermediation in the Euro Crisis

Academic and political concerns about a “European democratic deficit” have risen with the extension of European governing powers in the Maastricht Treaty and after the failure of the Constitutional Treaty. For a while, however, citizens seemed strangely unconcerned about the lack of political accountability of European governing powers and of Europe-wide public debates that might influence European policy choices. In Eurobarometer surveys, “trust in the European Union” continued at remarkably high levels and was generally much higher than the level of trust in democratically accountable national governments. But that has changed with the onset of the present crisis.

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<sup>1</sup>Published in: Helga Michalsky (Hrsg.), *Politischer Wandel in konkordanzdemokratischen Systemen*. Vaduz: Verlag der Liechtensteinischen Akademischen Gesellschaft, 13–24.

<sup>2</sup>Rainer Hank (2013) points to a disturbing continuity of Nazi visions of European unity and the ideas of some prominent promoters of European integration in postwar Germany.

## 2.1 What Has Changed

Between September 2007 and the end of 2012, average “trust in the EU” fell from 57 to 33 %, and the share of respondents expressing distrust rose from 32 to 57 % (Zalc 2013). In trying to interpret these changes in terms of democratic legitimacy, it is useful to refer to the conceptual distinction between an output-oriented and an input-oriented dimension (Scharpf 1999, Chap. 1)—between Lincoln’s “government *for the people*” and “*by the people*” or between “*responsible*” and “*responsive*” government (Mair 2009).

In normative political theory, the status of output-oriented legitimacy is primordial. The coercive powers of government, which are needed to deal with common problems that are beyond the reach of voluntary cooperation in civil society and of market interactions, may be abused by oppressive, predatory, vindictive or simply incompetent governors. Hence the legitimacy of government itself is in question if it fails to serve the common good of the community and to comply with its basic norms and standards of justice. In these terms, high levels of trust before 2007 may indeed express a relatively high level of output satisfaction which people tended to associate with the EU.

But why would citizens ignore the glaringly obvious deficits of input-oriented democratic legitimacy (Follesdal and Hix 2006) before 2007, and what seems to have changed in the crisis? What did in fact change are the preconditions of “legitimacy intermediation” (Scharpf 2012). Before the crisis, European policies generally had low political salience (Moravcsik 2002)—mainly because highly controversial proposals had no chance to be adopted under the high consensus requirements of European legislation. In any case, however, European directives had to be transposed by national parliaments and all European law had to be implemented and enforced by national courts and administrative agencies. Hence citizens were never directly confronted with the coercive power of EU government. And as their own governments were visibly involved in EU policy making, voters could and did use national elections to hold them accountable for the exercise of all governing powers, regardless of their origin at national or European levels (which may also explain generally lower trust in national governments). In short, high trust in the EU before the crisis may be plausibly taken as indicating output-oriented satisfaction combined with citizens’ lack of concern about input-oriented deficiencies at the European level.

In the meantime, however, European economies were badly hit by the international financial and economic crises triggered by the collapse of the Lehman Bros. bank in the fall of 2008. Subsequently, some member states of the European Monetary Union were threatened by sovereign insolvency—which was interpreted as a euro crisis that might have catastrophic consequences not only for the countries involved but for the European or even the world economy at large. Since this crisis is still dragging on, it is safe to assume that output satisfaction has declined.

What matters more, however, is that in the effort to “save the euro at any cost,” European authorities—the Council, the Commission, the European Central Bank and the “Troika”—have deeply, directly and highly visibly intervened in the lives

of millions of citizens and in the economic, social and institutional fabrics of “debtor states”. And while these efforts have not halted the economic decline and the rise of mass unemployment, they have disabled the effectiveness of input-oriented politics and democratic accountability in these states. Even in “creditor states”, moreover, parliaments found themselves confronted with precisely specified fiscal obligations which they could not reject without disavowing their commitment to European integration. From the perspective of citizens, in short, the exercise of European governing powers is no longer obscured by the accountability of national governments.

## 2.2 Input-Oriented Legitimacy of the Euro-Rescuing Regime

As a consequence, the legitimacy of euro-rescuing policies now needs to be justified through output- and input-oriented arguments focusing on the European level itself. What matters in the output dimension are their problem-solving effectiveness and their justice in allocating burdens and benefits. These criteria will be discussed on the basis of policy analyses in later sections.

Input-oriented legitimacy, however, implying democratic self-government and, in representative democracies, the electoral accountability of governors, is clearly lacking in the present euro-rescuing regime. This is most obvious for the European Central Bank which has become a crucial actor responsible for extremely effective and totally discretionary policy choices in recent years even though it is totally insulated against citizen-based political inputs and electoral accountability. Similarly the Commission, which is defining the “conditionalities” debtor governments must accept to receive the next installment of “rescue credits”, is neither directly nor indirectly accountable to the people whose jobs are to be eliminated and whose incomes are to be cut under its mandates.

But what about the Eurogroup Council under whose formal authority the Commission-defined requirements have been imposed on Greece, Ireland, Portugal and Cyprus, and will be imposed on all subsequent recipients of ESM credits? The finance ministers and heads of governments are indeed accountable to their own parliaments and voters—which legitimates them to accept sacrifices for their *own* country and to agree to *general rules* that will apply to all member states, including their own. But if what is at stake are *decisions* imposing specific sacrifices on Greece, others on Portugal and still others on Ireland, German voters could not possibly legitimate the Chancellor to impose special burdens on another country. From the perspective of Portuguese citizens, therefore, Council decisions have the quality of rule by foreign governments. And even if the agreement of the debtor government were formally required, it would have been obtained under duress or at least under extremely asymmetric bargaining conditions.

In short, therefore, the present euro-rescuing regime may be characterized either as an authoritarian expert regime or as a *dictat* imposed by creditor governments. In either case, it lacks the institutional preconditions of input-oriented democratic legitimacy. It cannot claim to be recognized as “government by the people”.

In normative democratic theory it is disputed whether output-oriented arguments alone could suffice to establish political legitimacy (Greven 2000)—a normative dispute that cannot be adequately addressed here. But if the regime is to be defended as “government *for the people*”, its claim to problem-solving effectiveness and distributive justice can indeed be examined by empirically based problem and policy analyses (Scharpf 1997). To assess present outcome, these need to examine the causes of the present crisis, the substantive policy options available and the institutional and actor-centered conditions under which they might have been adopted. Since these analyses cannot be fully developed here, I will draw mainly on my previous publications (Scharpf 2011, 2012, 2013a).

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### 3 Problem-Oriented Analysis: What Went Wrong

The structural deficiencies of the European Monetary Union (EMU) and their causal effect on the euro crisis are by now reasonably well understood (De Grauwe 2012, 2013; Notre Europe 2012): By joining the Monetary Union, member states lost both the external constraint of having to maintain a balance-of-payments and the capacity to respond to problems of inflation and unemployment through changes of the nominal exchange rate or through the instruments of expansionary or restrictive monetary policy. And though fiscal competences remained at national levels, their use for expansionary purposes was severely constrained by the Stability Pact. Moreover, member states could no longer turn to their national central bank as lender of last resort in case of a liquidity crisis, while liquidity support by the ECB and by other member states was explicitly ruled out by the prohibition of monetary state financing and by the no-bailout rule.

Competences for exchange-rate and monetary policy were centralized and exercised by the European Central Bank with a narrowly defined mandate to ensure price stability in the Eurozone. This regime, it was expected, would reproduce for the members of the Monetary Union the beneficial effects which the quasi-monetarist policies of the *Bundesbank* had produced for the German economy (Delors Committee 1989; Commission 1990).

#### 3.1 Centralized Monetary Policy in a Non-optimal Currency Area

It is widely acknowledged, however, that the Eurozone was not then and is not now what Robert Mundell (1961) had defined as an “optimal currency area” (OCA)—an economic space, that is, in which centralized policies have similar impacts on all regions.<sup>3</sup> In a monetary union, therefore, successful centralization presupposes

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<sup>3</sup> Regional disparities will of course also exist in most national economies; and in large federal states like the United States or united Germany they may be so significant that uniform monetary policy may also generate diverging economic effects in different regions. But in these federal

strongly converging inflation rates in all member economies (Flassbeck and Lapavistas 2013). In fact, however, the Eurozone included an extremely heterogeneous membership of former “hard-currency” and “soft-currency” economies with differing inflation dynamics driven by diverse sectoral structures, political-administrative institutions and practices and, above all, by different wage-setting institutions (Scharpf 1991; Soskice and Iversen 1998; Calmfors 2001; Höpner and Schäfer 2012; Höpner 2013; Iversen and Soskice 2013). Hence, even though the ECB did succeed in maintaining low inflation rates for the Eurozone as a whole, national inflation rates continued to differ systematically.

These inflation differences did not prevent the convergence of *nominal* interest rates. But they had the effect of converting these into higher *real* interest rates in low-inflation countries, and into very low or even negative real interest rates in the former “soft-currency” economies. Under these conditions, the monetary impulses of uniform ECB policies were too restrictive for the first, and too expansionary for the second group of economies (Walters 1990). In fact, high real interest rates did push the low-inflation German economy into the recession of 2001–2005, whereas in Greece, Ireland, Italy, Portugal and Spain (the GIIPS economies), domestic demand was stimulated by the sudden availability of extremely cheap credit.

Low-inflation Germany had become the “sick man of Europe” at the beginning of the decade, but eventually managed to fight its recession through union wage restraint and supply-side reforms. In combination, these measures facilitated an export-led recovery and a considerable expansion of low-wage employment. At the same time, however, the constraint on domestic demand and rising exports contributed to external imbalances through increasing current-account surpluses and a progressive under-valuation of the real exchange rate. In the GIIPS economies, by contrast, credit-financed domestic demand continued to rise, and so did imports, economic growth in the non-traded (particularly the real-estate) sector, employment and wages. And again, the effects were dynamically increasing external imbalances. Current-account deficits were continuously rising, and the increasing over-valuation of real-effective exchange rates added to the effect by penalizing GIIPS exports, just as German exports were subsidized by a massive real under-valuation.

Remarkably, however, these imbalances were not treated as a cause for concern by European or national policy makers. Rising GIIPS deficits were easily financed by capital inflows from Germany and other surplus countries, and thus seemed to confirm the initial expectations of beneficial catch-up development (Commission 1990). The ECB on its part had met its mandate by constraining average consumer-price inflation in the Eurozone and saw no justification for intervening against asset-price inflation and the real-estate bubbles in Ireland and Spain. And since the

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states, the divergence-increasing effect of monetary impulses will be counteracted by the equalizing effects of uniform national taxation, centralized social policy, horizontal and vertical fiscal-equalization programs, and of course by opportunities for labor mobility that are not constrained by language and institutional barriers. In short: the Eurozone is a non-optimal currency area because it is not a large federal state.

Stability Pact defined limits on national fiscal deficits (which were extremely low in Ireland and Spain, and no higher in Portugal than in Germany), neither the ECB and the Commission nor national governments had a sense of an impending catastrophe. But all that changed with the onset of the international financial crisis in the fall of 2008.

### **3.2 The Impact of the International Financial Crisis**

The immediate effect of the Lehman collapse was a world-wide credit squeeze which brought all economies to their knees and forced all governments and central banks to resort to “Keynesian” reflation and to save their “system relevant” banks. Thus public-sector deficits escalated everywhere. But the credit squeeze hit hardest on those Eurozone economies that had become totally dependent on capital inflows from abroad. When these stopped abruptly, the recession in GIIPS economies was even deeper than elsewhere—which also meant that their public-sector debts increased even more steeply. In effect, a large overhang of insecure private-sector debt was transformed into public-sector debt. And when capital markets finally responded in early 2010 by challenging the solvency of deficit states, their economic decline was compounded by acute state-credit crises.

What went wrong, in short, is that Monetary Union in a non-optimal currency area and uniform ECB monetary policies had produced dynamically diverging real exchange rates and current accounts among Eurozone economies, which had been completely ignored by European and national policy makers. Under the credit squeeze of the international financial crisis of 2008, however, the extreme dependence of deficit economies on capital inflows had become a massive economic liability and then a cause of speculative attacks on the solvency of deficit states, first in Greece, and then in Ireland and Portugal as well. And since potential insolvencies of individual euro states were perceived as challenges to the survival of the Monetary Union itself, by May of 2010 European policy makers had agreed to “save the euro at any cost.”

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## **4 Basic Policy Options**

As European and national policy makers had paid no attention to the rise of external imbalances, one also should not presume that the causes of the crisis and the effects of available policy options were initially well-understood (Hall 2012). By hindsight, however, there were basically three distinct policy options which policy makers could have chosen in dealing with the Greek and subsequent state credit crises. They could be described as

- Tough luck under Maastricht rules,
- Solidaristic burden sharing, and
- Rescue credits with tough conditionalities

Under the pressures of the Greek crisis in early 2010, the first option was rejected, and the second one was never seriously considered. Nevertheless, an examination of these “nondecisions” (Bachrach and Baratz 1963) is useful for understanding why the third option was actually adopted.

## 4.1 Tough Luck Under Maastricht Rules

Of the three options, the first one had been prescribed by the Maastricht rules that had only recently been confirmed in the Lisbon Treaty: Even if the interest rate on Greek bonds did rise to a level where the costs of refinancing the state debt would exceed available resources, Art. 123 TFEU prevented the ECB from buying Greek state bonds, and Art. 125 TFEU prevented the Union and all member states from assuming any liability for Greek debts. If that meant that international capital markets would drive the Greek state into bankruptcy, tough luck.

In institutional terms, this was also the option that would have been most easy to adopt. The Maastricht rules were the law of the Treaty which could only be changed by unanimous agreement among all EU governments and ratification in all member states. In other words, every single EMU member state could have vetoed decisions that violated these rules. But what about actor perceptions, interests and preferences?

On the Greek side, the incoming Pasok government had won the 2009 elections on promises of rapid economic recovery. After coming into office, however, it had inadvertently triggered the credit crisis by announcing that its predecessors had vastly under-reported past state deficits. From its perspective, therefore, the immediate prospect of state insolvency must have appeared as a political catastrophe—compared to which applying for European support must surely have appeared as the lesser evil.

From the perspective of surplus states, the choice was more difficult. In Germany, the spontaneous preference of Merkel’s conservative-liberal government was to insist on the Maastricht rules—which, after all had been adopted at German insistence and which also had the support of the neoliberal academic mainstream and business press. It took a while for the government to realize that letting Greece go bankrupt might trigger speculative attacks on the solvency of other EMU member states whose economies had also become dependent on capital inflows—with the consequence that the Monetary Union itself might break apart on the fault line dividing surplus and deficit economies. If that should happen, the huge external-credit position which surplus economies had built up during the first decade of the Monetary Union would be at risk, and surplus states might again have to save their domestic banks. Moreover, governments and unions also came to realize that exports had greatly benefited from an undervalued real exchange rate, and that a collapse of the euro was likely to produce a major revaluation of nominal exchange rates and massive job losses. After some reflection, therefore, governments in Germany and other surplus countries realized that there were



good self-interested reasons for not rejecting the request for assistance in resolving the Greek solvency crisis.

## 4.2 Solidaristic Burden Sharing

The second approach might have been familiar to policy makers and the public in Germany since it was the one they had chosen in dealing with the consequences national unification after 1990. When vastly diverging real exchange rates were wiping out industries and jobs in East Germany, monetary union was quasi-automatically followed by social and fiscal union. In effect, West-East transfers supporting social security, public infrastructure and economic investment have amounted to about 3 % of GDP over more than 20 years. And while transfers of this magnitude may be unlikely in the Eurozone, a solidaristic “framing” would indeed have suggested policy responses differing greatly from the ones that were actually chosen.

It is now widely accepted that an immediate commitment either to jointly secured Eurobonds or to OMT interventions by the ECB would have put an end to both, the Greek state-credit crisis and the threat of an imminent euro crisis (De Grauwe 2012). Once that fear had been allayed, there would then have been time to assess the causes of the crisis and the effectiveness and normative appropriateness of potential remedies from an inclusive perspective. If the euro was to be saved and external devaluation was ruled out, policy discussion would then have turned to “internal devaluation” as a way to achieve external balance through wage and price cuts. But as that would also have highlighted institutional obstacles, counterproductive economic effects and enormous social costs, inclusive policy discussion and negotiations could not have avoided focusing on the need to mitigate these problems through European or transnational social transfers and investment subsidies. Hence agreed-upon solutions would not only have required difficult internal adjustments in deficit economies but also substantial fiscal contributions from surplus states.<sup>4</sup> But such options were not seriously considered in the spring of 2010.

An obvious reason is that in institutional terms they would have been most difficult to adopt. Since they would have directly violated the Maastricht rules, they would have required Treaty amendments supported by all EMU member states or at least an international-law treaty among Eurozone states. But given these institutional obstacles, such options could only have succeeded if they had had

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<sup>4</sup> It is also suggested by Keynesian economists that a solidaristic response would have required a strong expansion of domestic demand through deficit spending, wage increases and higher inflation rates in Germany and other surplus economies (De Grauwe 2013). Even if that were institutionally feasible, however, the effect on GIIPS economies would be quite small as the share of Germany in the export and import balances of GIIPS economies, and vice versa, has been greatly reduced after 2008 (Erber 2012).

overwhelming political support among governments and political publics in the Eurozone.

As governments of deficit states would probably not have objected, what ultimately mattered were perceptions and preferences in the surplus states. In German unification, the emotional appeal to national solidarity was not politically challenged—and if it had been, the argument that “we had jointly started and lost the War” would have settled the issue. In the Eurozone, by contrast, appeals to solidarity would not have resonated emotionally with a pre-existing “thick” collective identity. And more reasoned appeals arguing that “we were jointly responsible for the faulty design of the Monetary Union and for its present crisis” had no basis in public perceptions and political debates in 2010. Instead, public attention in Germany and other surplus states was made to focus on what had been and still was glaringly wrong in Greece—which silenced potential political support for a solidaristic “framing” of the euro crisis and supported the regime that was actually established.

### **4.3 Rescue Credits, Austerity and Structural Reforms**

The euro-rescuing policies chosen in May of 2010 combined rescue credits to challenged states with tough conditionalities that had to be accepted and implemented by recipient governments under the threat of insolvency. The credits at (somewhat) lower interest rates were provided by a succession of rescue funds, increasing in size from the temporary EFSF created in May of 2010 and the EFSM to the permanent European Stability Mechanism (ESM) established in September of 2012 through an international-law agreement outside of (but subsequently allowed by) the EU Treaty. The country-specific conditionalities were and are defined and periodically updated by the Commission, and compliance was and is controlled by a “Troika” of inspectors from the IMF, the ECB and the Commission.

The main thrusts of these conditionalities have been extremely tough and rigid rules of fiscal austerity and detailed requirements for “structural reforms” to deregulate and liberalize labor and service markets. Their ostensible purpose was to reduce the need for additional state credits through severe cuts in welfare spending, public employment and public-sector wages, and to reduce external deficits by improving external competitiveness through internal devaluation. At the same time, the ECB also tried to stimulate demand for the bonds of crisis states by flooding the banking system with cheap longer-term credit, and in July of 2012 by President Draghi’s pledge that the ECB would do “all that it takes” to save the euro through Outright Monetary Transactions (OMT)—i.e., direct interventions in the market for state bonds.

In institutional terms, this strategy neither followed the Maastricht rules nor rejected them explicitly. Instead, it fudged them in practice while trying to meet legal challenges by staying within the outer bounds of interpretation (ECJ case 370/2012, Pringle; Franke 2013). But it could have been stopped by any one of the Eurozone governments insisting on strict compliance with these rules. The institutional setting thus had the characteristics of a compulsory negotiation

or “joint decision” system (Scharpf 2006) in which binding decisions depended on unanimous agreement.

In the relation between surplus and deficit countries, however, this constellation was and is characterized by an extreme asymmetry of bargaining powers. Once a government had chosen (even if reluctantly, as in the Irish case) to avoid insolvency by applying for rescue credits, it could no longer reject Commission-defined Memoranda of Understanding. So what ultimately mattered for the shape of the rescue program was the Commission’s view of what was feasible (on which recipient governments could express their views) and of what was acceptable to creditor governments. Among these, initial perceptions, interests and normative preferences may have varied somewhat, but Germany as the largest contributor generally had a decisive voice.

Even though most deficit states could certainly not be accused of “fiscal profligacy and irresponsibility”, perceptions of the euro crisis were framed by the Greek case. And though creditor governments were saving the euro for self-interested reasons, they would still blame debtor governments for the predicament. That may explain the moralistic rigidity with which strict austerity requirements continue to be defended long after it became obvious that they were pushing debtor economies into an economic depression that directly counteracted the initial goal of reducing the need for state deficits.

In the meantime, however, the ECB’s pledge of OMT interventions has calmed the fears of imminent state credit crises, and the Commission has shifted its analysis to the dangers of excessive external imbalances and lost competitiveness (Commission 2010, 2012). Compared to the earlier obsession with state deficits, this perspective does focus on the structural problems of the Monetary Union which had produced vastly diverging external balances distorting export and import flows. As these might continue to invite speculative attacks on the solvency of indebted deficit states, they should indeed be corrected to stabilize the common currency. And since the adjustment of nominal exchange rates was out of the question, the euro-rescuing program had to impose internal devaluation on deficit countries with vastly overvalued real exchange rates.

Even in this revised frame, however, fiscal austerity was to be maintained because it would reduce domestic demand and hence imports. But the main emphasis is now on the need for deep-cutting structural reforms which are meant to improve external competitiveness by reducing wages and prices. In Germany (and even more so in Slovakia and the Baltic states), this emphasis also resonates with the conviction that they themselves had overcome their own crises through tough and painful structural reforms facilitating an export-led recovery. And if they had done it, why shouldn’t the debtor states do so as well?

In short, therefore, the present euro-rescuing regime is institutionally entrenched as an extremely asymmetric intergovernmental negotiation system in which debtor governments have practically no bargaining power. And since its present policies imposing fiscal austerity and structural reforms as a condition for receiving rescue credits serve not only the economic and fiscal self-interest of creditor states but also resonate with the cognitive and normative perceptions of their governments and publics, the regime appears as an extremely asymmetric variant of a “joint-decision

trap” (Scharpf 1988, 2006) which is highly resistant to policy change. So, returning to the question left dangling above, how should this regime be assessed in terms of output legitimacy?

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## 5 Output-Oriented Legitimacy of the Euro-Rescuing Regime

Such an assessment must refer to a regime’s problem-solving effectiveness as well as to criteria of distributive justice. In the first of these dimensions, and in terms of its primary goals, the euro-rescuing program appears as a partial success.

### 5.1 Immediate Goals

So far, no EMU member state has been declared insolvent. For the time being, speculative attacks were stopped by the ECB’s announcement of OMT interventions, whereas intergovernmental rescue credits were generally considered “too little and too late” to impress capital markets. Nevertheless, Ireland is now confident to refinance its debt at reasonably low market rates without further help from the rescue fund, and Portugal hopes to follow its example.

At the same time, however, the ostensible purpose of reducing the need for public-sector credit has not been achieved. Fiscal austerity has reduced domestic demand so much that the loss of economic activity and the steep rise of unemployment have reduced public-sector revenues and increased expenditures to such an extent that public-sector indebtedness is now generally higher than at the beginning of the crisis (Andini and Cabral 2012). But since the Commission has shifted its emphasis from public-sector debt to external accounts and competitiveness, what seems to matter more in its view is the progress toward internal devaluation that is suggested by a recent decline of current account deficits and of average unit labor costs in the debtor countries (Commission 2013a). These indicators, however, need to be interpreted with some caution.

### 5.2 Fragile Improvements

If the rise of external indebtedness exposes debtor states to speculative attacks on their solvency, the improvement of current accounts is indeed good news. It appears, however, that the reduction of deficits was mainly due to the drastic decline of imports, and hence to a fall of domestic demand, whereas exports were rising at about the same rate before and after the crisis.<sup>5</sup> Similarly, the fall of

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<sup>5</sup> Comparing the rise of real exports in 2003–2007 and in 2009–2013, it is hard to see a general improvement in the second period that could be ascribed to austerity and structural reform policies:

average unit labor costs is highly correlated with employment losses (Sinn 2013; Commission 2013b).<sup>6</sup> In other words, the recent improvement of both indicators may be more a symptom of the continuing economic crisis than of economic recovery. Thus the improvements remain vulnerable to a reflation of domestic demand that would again increase imports and unit labor costs by increasing employment in jobs with lower productivity. It makes sense, therefore that creditor governments and the Commission insist that austerity and structural reforms cannot be relaxed because debtor economies still have a long way to go before external balances will be supported by export-oriented growth.

### 5.3 Unequal Distributive Effects

In any case, however, the limited improvements from the euro-rescuing perspective were achieved at the price of a dramatic deterioration of domestic conditions in debtor states. Austerity policies have deepened the decline of economic activity, while severe cutbacks of social benefits, public services and public-sector wages combined with labor market deregulation have greatly increased mass unemployment, poverty and social inequality (see, e.g., Koutsogeorgopoulou et al. 2014). Employment has dramatically declined in all debtor states, and in some youth unemployment has soared to more than 55 %. Lower rates in Ireland reflect massive outmigration which, however, is also increasing in other debtor states. In short, the price of euro-rescuing policies has been prolonged economic decline and deepening social crisis in debtor states.

From the perspective of creditor states, by contrast, the euro-rescuing policies must be considered a success. As the collapse of the euro has so far been averted, their external (private and public) asset positions did not have to be written off, and effective budgetary outlays for the euro-rescue funds are minimal as yet. In economic terms, they have by and large recovered from the effects of the international financial crisis, and Germany has even achieved record export surpluses. In terms of distributive justice, therefore, the decision to “rescue the euro at any cost” has led to extremely asymmetric outcomes where practically all the costs of rescuing the common currency are borne by the debtor states and their citizens.

### 5.4 Ambivalent Problem-Solving Effectiveness

That also suggests the assessment of the regime’s problem-solving effectiveness should be positive from the perspective of creditor states. From the perspective of

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Ireland 27.9/14.4 %; Greece 24.3/4.5 %; Spain 21.6/28.2 %; Italy 26.6/20.8 % and Portugal 25.2/28.7 % (Source: Eurostat).

<sup>6</sup>Since firms and jobs with low productivity are likely to be the first victims of an economic downturn, average productivity would rise in a crisis, and hence *average* unit labor costs would decline even if the competitiveness of the remaining firms had not changed.

debtor countries, by contrast, a positive evaluation would depend on the belief that present sacrifices and much greater social inequality are a price worth paying for future economic growth. The intensity of political protest suggests that citizens of debtor states do not generally share this belief. Nevertheless, it may be held by some of their present governments—just as it had shaped the 2004 reforms of the Schroeder government in Germany. But there are important differences. In terms of input legitimacy, it matters of course whether sacrifices are externally imposed or designed, defended and adopted by a democratically accountable government with a view to the overall economic and social fate of their constituency.

And the same difference may also matter for problem-solving effectiveness. The euro-rescuing regime was not created to save Greece, but to save the euro. And if its rescuers are convinced that the common currency is vulnerable to speculative attacks on the solvency of member states with external deficits, it does not really matter from their perspective whether deficits are reduced through higher exports or lower imports, or whether balance is achieved at higher or lower levels of economic activity.

This is not meant to suggest that the Commission, the ECB or creditor governments would not prefer debtor states to achieve German-type export-led economic growth. But they will also know that the German recession of 2001–2005 was far less severe than the present crises in debtor states. Moreover, German industries were well placed in international markets and thus did benefit immediately from union wage restraint and supply-side reforms. Exports, after all, depend first of all on a portfolio of domestic production that matches existing external demand. Where that is lacking, limited wage and price reductions will have no immediate effect on demand or on new investments. Nevertheless, the Commission's conditionalities have not even tried to go beyond wage-reducing reforms in trying to stimulate investment and innovation. Given the generally mixed success of targeted industrial policies, that may be wise. But then one should also not expect to achieve external balance primarily through German-type export-oriented economic growth.

Compared to the difficulties of stimulating exports, the control of imports appears much more feasible. They are directly affected by domestic demand<sup>7</sup>—and demand can be effectively reduced through fiscal constraints. So even if exports should not rise, current-account deficits and the vulnerability of the euro could still be averted through imposed austerity. It seems consistent, therefore, that current reforms of the Monetary Union (apart from efforts to reduce the vulnerability of the banking system) have also concentrated almost entirely on creating and strengthening European controls over national fiscal policy—ranging from the European Semester and the Two-Pack and Six-Pack regulations to the constraints

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<sup>7</sup> For tradable products without domestic substitutes, imports are likely to vary proportionately with GNP. For substitutable products, imports should rise disproportionately if domestic demand exceeds local production (as was true in deficit economies between 1999 and 2008), and they should decline disproportionately if demand falls below domestic production.

of the Fiscal Pact in national constitutional law. They seem eminently suitable for defending the euro by preventing external deficits—even in the absence of economic growth.

From the perspective of citizens in debtor countries, however, who must care for their present and future economic and employment opportunities, the effectiveness of the present euro regime appears at best ambivalent. They may, perhaps in Ireland, hope for a significant fall of unemployment in the near future. But they may also find themselves entrapped in a regime that enforces external balance at the price of economic stagnation, low employment and poverty.

For the Eurozone as a whole, the Excessive-Deficit and Excessive Imbalance Procedures of the Sixpack regulations<sup>8</sup> have generalized and extended the principles of the euro-rescuing regime to all member states—whether or not they have applied for ESM credits. In institutional terms, these regulations have in no way remedied the input-oriented democratic deficit (Scharpf 2011, 2012). And in output-oriented terms they imply that any country whose economy is hit by a recession will only be allowed to cope with it through fiscal austerity and supply-side reforms. In effect, this amounts to a regime of sequential internal devaluations in the Eurozone which will favor capital interests and exert a permanent downward pressure on state functions and labor interests (Scharpf 2013a).

In short, the assessment of the present euro-rescuing regime's overall problem-solving effectiveness remains ambivalent at best. Its evaluation is shaped by conflicting distributional interests and also by different attitudes toward irreducible cognitive uncertainty and toward the inter-temporal incidence of benefits and losses. Under such conditions, policy analyses may perhaps help to clarify the issues. But the final assessment of output legitimacy must in any case be left to the "people" on whose acceptance the authority of governing powers ultimately depend.

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## 6 Potential Exits from the Euro-Rescuing Trap

The present euro-rescuing regime, so I have argued, lacks input-oriented democratic legitimacy and it produces highly unequal distributional effects. Hence even though the assessment of its problem-solving effectiveness remains ambivalent, it seems safe to assume that a great many citizens and political actors among the Eurozone "people" would, with the advantage of hindsight and a full understanding of its implications, have opposed the regime's establishment in 2010 and would prefer to see it changed now. For them, the question is whether a change of directions is still possible.

The present institutional setting of self-interested intergovernmental bargaining and legally binding agreements seems to exclude that possibility. The governments

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<sup>8</sup> Council Regulations (EU) 1173/2011; 1174/2011; 1175/2011; 1176/2011; 1177/2011; Council Directive 2011/85/EU.

of surplus countries benefiting from the regime have no incentive to change their position, and debtor governments that would prefer a solidaristic transfer regime lack the bargaining power to change the agreements by which they are bound. But could this asymmetric equilibrium be upset? In the spirit of informed speculation, I could envision two such scenarios: A switch from asymmetric bargaining to democratic majority rule at the European level or a switch from the joint-decision mode to unilateral action.

## 6.1 Majoritarian Democracy

The first of these scenarios is associated with present hopes for a politicization of the upcoming elections for the European Parliament: If EP party families will each present a common candidate for the Commission Presidency and a Europe-wide political platform they may also have to take a stand on euro-rescuing policies. In that case, a politically legitimated President backed by a parliamentary majority might, somehow, achieve an institutional transformation of the euro regime—replacing asymmetric intergovernmental bargaining by democratic majority rule. The obvious risk is, of course, that any politicization of the euro crisis would primarily mobilize actual and potential losers to the advantage of anti-European parties everywhere. Worse yet, competition among pro-European parties, campaigning in Greece as well as in Estonia, and in Germany as well as in Italy, could not avoid dramatizing distributive and normative conflicts—not just in the usual left-right dimension but between Northern creditors and Southern debtors, Northern export workers and Southern work seekers, Northern taxpayers and Southern welfare clients, and so on. The escalation of transnational conflicts, I have argued, would put Europe-wide consensus beyond reach, and majority rule could tear the Union apart (Scharpf 2013b). Just as in the recent German elections, therefore, pro-European parties are most likely to shun controversial discussions of the euro crisis—which also means that the outcome of EP elections cannot challenge the asymmetric intergovernmental and expertocratic character of the present euro regime.

## 6.2 Unilateral Action

From an analytical perspective, however, the institutional stability of the present euro regime appears quite vulnerable. It could of course be jolted out of its present equilibrium through another financial or banking crisis. But a similar shock could also be triggered by the action of one or more of the governments involved. To appreciate this possibility, we need to shift to a game-theoretic interpretation of the present constellation in which unilateral moves are not excluded by legally binding constraints.



For a first move, one might imagine that the government in Greece or another debtor state may be captured by a majority of anti-European protest parties determined to reject the actual (or in the Italian case, anticipated) austerity and internal-devaluation requirements of the present regime. In effect, this unilateral defection would transform the institutional constellation from a “co-operative” bargaining system into an anarchic field with strategic interactions in a “non-cooperative” game (Scharpf 1997, Chap. 5). In a second move, the ESM would then stop the next installment of rescue credits, and the ECB would honor its pledge to provide OMT support only for states complying with ESM rules. If that were to happen, international financial markets would, in a third move, respond again to the possibilities of sovereign default and a collapse of the euro. In other words, the original specter of an uncontrollable euro crisis would arise again. And if it would turn into an international financial crisis, the catastrophe might even open the way for a new Bretton Woods.

It seems more likely, however, that a credible threat of unilateral defection would provoke hectic European efforts to rebuild a euro-rescuing settlement. But even if the defecting governments were willing to re-negotiate, the constellation would be radically transformed by the change of the “default outcome”. As of now, the present euro-rescuing settlement will continue unless everybody agrees to change it. After the defection, however, there would be no settlement unless everybody agreed to create one. In other words, the constellation would be institutionally similar to the one which had existed in the spring of 2010. Nevertheless, the outcome could be very different because the perceptions and preferences of governments are likely to have changed in the meantime.

Unlike their predecessors, the defecting governments would now be aware of the social and economic costs entailed by asking to be “rescued” by Europe. By comparison, the specter of bankruptcy, followed by exit from Monetary Union and devaluation, may also appear less politically horrifying than it did in 2010. Moreover, these governments will have come to realize how much the settlement reached in 2010 had served the fiscal and economic self-interest of creditor states—which should further harden their bargaining position on demands for a less unequal settlement approximating the option of a “Transfer Union”.

However, perceptions and preferences in creditor countries would have changed as well. After 2010, private capital has greatly reduced its risk positions in deficit economies—with the effect that most of their continuing external indebtedness is now represented in the “Target-2 balances” of national central banks, rather than in the balance sheets of Northern private banks (Sinn and Wollmershaeuser 2011). And while some creditor governments may now be more sympathetic to the plight of debtor societies, the new Baltic member states are likely to be even tougher than Finland. In Germany, moreover, the specter of a euro crisis may appear less horrifying as exports have shifted from the Eurozone to Asia and the Americas. And while it is still believed that nominal exchange rates would rise after a breakup of the Monetary Union, the fact that the Swiss central bank was able to stop the escalation has been duly noted in Germany.

In light of these changed perceptions and preferences, attempts at re-negotiating a euro-rescuing regime might well fail; and the collapse of the Monetary Union might, with the benefit of hindsight, allow for the construction of better long-term solutions. If a euro-rescuing agreement should be reached, however, it could hardly be as asymmetrical as the present one. Beyond that, however, the outcome could not be predicted. It might range from the economically counterproductive combination of rescue guarantees with relaxed conditionalities and minimal intergovernmental transfers to a more generous “Marshall Plan” or even to one of the heterodox parallel currency schemes that would have no chance of being considered in the present veto constellation (Schuster 2014).

In short, if one or more debtor states should come to reject compliance with the present euro-rescuing regime, the eventual outcome could not be predicted on the basis of presently available information and theory. But it seems clear that such challenges could jolt the existing regime out of its equilibrium—and while their probability may appear low in light of present optimism, it should not be discounted to zero. Instead, it would be reassuring to know that policy staffs and think tanks in Brussels, Frankfurt and national capitals are at work exploring the potential trigger events and political and economic implications of such challenges and of potential policy responses.

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## 7 To Conclude

The dramatic decline of citizens’ trust in the European polity in recent years is a consequence of the higher political salience and lower factual plausibility of arguments adduced to legitimate the exercise of governing powers at the European level. The European regime that has been created to deal with the euro crisis after 2010 appears glaringly deficient by the standards of input-oriented democratic accountability. And any claims to output-oriented legitimacy are marred by the regime’s extremely unequal distribution effects as well as by its contribution to the deep economic and social crises of debtor states and their uncertain prospects for economic recovery. Under these conditions on the output side, efforts to improve input legitimacy through the politicization of EP elections are likely to exacerbate transnational conflicts. In spite of the seeming stability of the asymmetric bargaining constellation, however, the present regime remains vulnerable to unilateral challenges that might either destroy or transform the Monetary Union.

In short, the legitimacy of European integration has been damaged by the economic over-integration of the Monetary Union and by the governing regime that was established to deal with the ensuing euro crisis. If European legitimacy is to recover, the present euro regime needs to be transformed.

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