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ORIGINAL PAPER

The EU's response to the global financial crisis and sovereign debt crisis

Economic governance under stress?

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Abstract Since the sovereign crisis erupted in the autumn of 2009 when the true scale of the Greek fiscal deficit was revealed, the European Union (EU), and especially the euro area, has staggered from crisis to crisis. Major initiatives have, however, been taken to improve economic governance and to put in place a more resilient framework for the euro. This article assesses how the EU has responded to the crisis and offers explanations for why the reform process has been slow and indecisive. It shows that potentially enduring solutions are on the table, but that they have been hard to introduce because of differing national perspectives and disagreements about how the burdens of adjustment should be shared. The article concludes by setting out plausible options and explaining what they entail.

Introduction

Although most of the EU experienced the direct effects of the global financial crisis that broke with the demise of Lehman Brothers in September 2008, with only Poland avoiding any downturn, it appeared by the summer of 2009 that the majority of Member States had weathered the storm. Yet since the sovereign debt crisis erupted in the autumn of 2009 when the true scale of the Greek fiscal deficit was revealed, the EU, and especially the euro area, has staggered from crisis to crisis. Task forces have been set up and have reported, legislation has been enacted and massive new financial instruments have been created. Yet still, the crisis rumbles on.

This paper examines how the EU has responded to these crises, presents an overview of the principal initiatives that have been undertaken and assesses why the problems appear to be so intractable, concentrating on the euro area. The next section briefly recalls the governance framework that was put in place for the launch of the euro and identifies some of its strengths and weaknesses. The following section presents an overview of the stages of the crisis, how they were dealt with and the deeper problems they revealed. The paper then assesses the main changes, and offers a judgement on whether they go far

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enough to ensure long-term stability, and is followed by a discussion of the political economy challenges the EU now faces. A concluding section looks at how the EU has coped and speculates on the further governance reforms likely to be needed.

The pre-crisis governance framework

The Treaty on European Union, dating from 1992, was the basis for the economic governance framework that was in place in Europe on the eve of the crisis. Its main features are assignment of monetary policy to the EU level for the 17 euro area countries (plus a further four that effectively shadow the euro by having currency boards or similar arrangements), but national competence for fiscal policy and structural policies. Fiscal policies are constrained for all 27 Member States through the excessive deficit provisions of the treaty which establish rules on fiscal discipline. What are known in the jargon as participating Member States are also subject to the corrective arm of the Stability and Growth Pact (SGP), with the threat of fines for those that do not correct an excessive deficit in a timely manner.

Member States are, separately, subject to surveillance of their economic policies through what is known as the Broad Economic Policy Guidelines which are to provide a steer to the conduct of macroeconomic and supply-side policies, and cover a wide range of policy domains. These guidelines are now incorporated into the Europe 2020 strategy which is a coordination process intended to ensure the coherence of national policies. The latter strategy is a successor to the Lisbon strategy first launched in 2000, then re-launched in 2005 with growth and employment as its core objectives. This re-launch also brought together previously separate coordination processes for economic and employment policy. However, in these coordination strategies the role of the EU level is confined to recommendations that Member States may take into account, but can (as they often have) largely ignore without facing any sanctions. As a result, the pressures on governments to comply are not strong.

There is also the difficulty of how to contend with what can be called the *adding-up problem*. The risks for any Member State depend in part on the policies that others adopt, so that monitoring and mediating the effects of policies that 'spill over' could be a significant part of an EU-wide preventative approach. At present, there is no easy way to prevent the individual decisions of national governments becoming an unsatisfactory aggregate for the EU as a whole. This could arise in various circumstances: too many governments pursuing fiscal policies that are restrictive and thus exert a collective squeeze on demand or, vice versa, that are lax, fuelling inflationary pressures; over-reliance on net exports as the principal source of growth; or a reluctance to implement politically difficult supply-side reforms, increasing the likelihood of macroeconomic imbalances.

All of these issues are especially salient for the euro area, not least because the aggregate of Member States inevitably has an impact on monetary policy decisions taken for the area as whole. Specifically, because the European Central Bank (ECB) has to take account of conditions in the euro area as a whole in its policy choices, what any single member does has a relatively smaller cost for it in terms of a monetary policy reaction than if monetary policy and economic policy are at the same geographical level, making free-riding more tempting.

It is also worth emphasising, especially given the current debates on Greece, that membership of the euro area was meant to be irrevocable. Indeed, there is no treaty

provision for leaving the euro and an examination of the constitutional options shows that there is no formal process for a country either to leave the euro, or to be expelled from it (Athanassiou 2009). The Lisbon Treaty did, though, include a provision not in previous treaties to allow a member to leave the EU completely, which could be the only way to exit the euro, unless a political over-ride of the treaty were to be applied.

An unfolding crisis…and response to crisis

Since mid-2009, the economic trajectories of the Member States have become much more unbalanced, with GDP performances ranging from the robust growth in Poland and a strong recovery (possibly about to stall) in Germany, to the near meltdown of the Greek economy that has accompanied its long-running debt crisis. Although most macroeconomic forecasts now envisage lower growth in 2011 and 2012, they do not foresee a double-dip recession as some commentators fear. Thus, the commission's autumn forecasts, published on 10 November 2011, have scaled back the projection for growth in 2012 from 1.8% (as forecast in the spring of 2011) to just 0.5%, and the forecast for 2013 is for growth of 1.3%. In both 2011 and 2012, Greece and Portugal are the only countries expected to see further GDP loss before returning to slow growth in 2013. Only anaemic growth of between 0.1% (Italy) and 0.9% (Germany) is foreseen for the five largest EU economies in 2012, picking up a little in 2013.[1]

Initial stages of the crisis

From the middle of 2008 onwards and especially after Lehman, it became clear that a global recession was occurring, and the sharp fall in GDP in so many countries in 2009 testified to the intensity of the fall, although it is also noteworthy that in most EU Member States the effect on unemployment was quite muted. Exceptions were Spain and Ireland where the downturn was especially pronounced in the construction sector and was accompanied by rapid labour shedding.

At EU level, there were responses in monetary policy, fiscal policy and in measures to maintain employment. A stimulus package amounting to some €200 billion over 2 years was launched with great fanfare on 26 November 2008, made up of €170 billion from the Member States and €30 billion from the European Commission and the European Investment Bank. Figure 1 shows the shares of the European stimulus package in 2009, according to Von Weizsäcker and Saha (2009), revealing that the Commission share was just 7%. In total, the 2009 package amounted to about 1% of EU GDP, with the larger countries contributing most to it, except for Italy which actually had a small fiscal retrenchment of 0.3% of GDP. The EU aggregate fiscal stimulus was well below the equivalent US figure of 1.7% of GDP. However, these authors also show that a rather larger stimulus was put in place from various guarantees and credits.

[1] The very poor record of macroeconomic forecasting by all the leading organisations during the crisis suggests that these forecasts have to be interpreted with great caution.

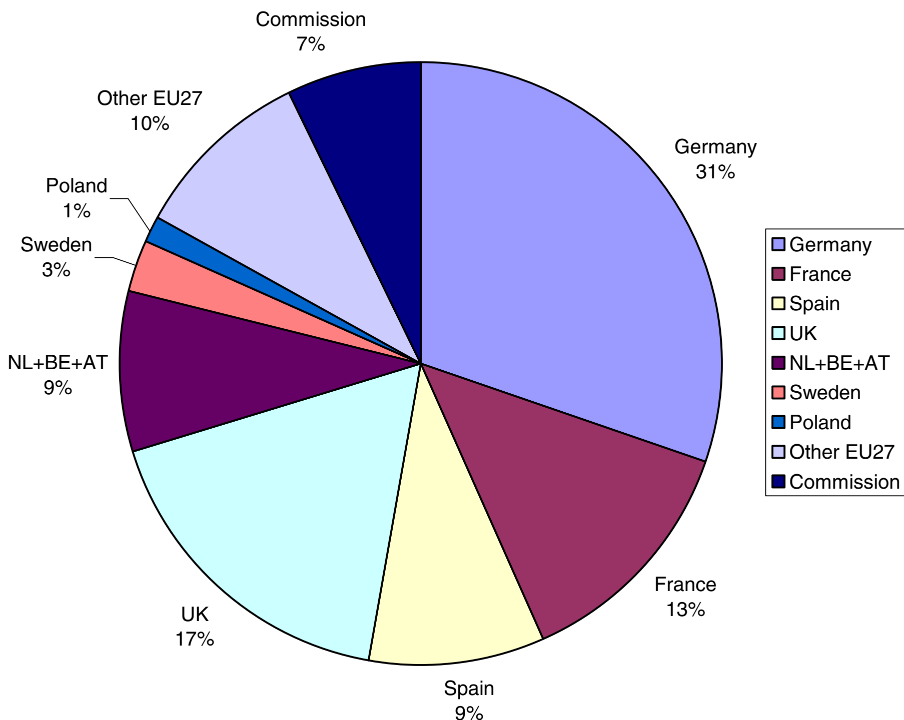

Fig. 1 The 2009 fiscal stimulus in Europe. Source: Own elaboration from data in Von Weizsäcker and Saha (2009)

Financial regulation and crisis responses

As early as August 2007, the ECB reacted rapidly to the stormy weather from the US sub-prime crisis by injecting liquidity into the financial system. Much more extensive responses to the banking crisis were put in place shortly after the Lehman Brothers collapse in 2008 as the scale of the systemic perils became increasingly clear and urgent. Over the next 3 to 6 months, many governments moved rapidly to shore up equity and to offer guarantees to depositors in a phase of response that can best be described as fire-fighting. Ireland was quick to offer a blanket guarantee to depositors in a very over-extended Irish banking system, a decision which the current government no doubt now regrets. In the UK, equity injections, guarantees and central bank liquidity were all used to prop up several of the largest banking groups, and a shotgun marriage was arranged between the relatively sound Lloyds TSB and the hugely over-lent HBOS. A number of smaller former building societies were either nationalised or absorbed (for example, by the Spanish bank Santander).

Elsewhere, the picture was more mixed. In France, Italy and Spain, few problems arose, partly because bank regulation had been more robust and, in several cases, banks were less international in their outlook. However, the Benelux bank, Fortis, had to be recapitalised, broken up and sold. In Germany, Hypo Bank had to be rescued and there were fears for some of the Austrian and Nordic banks that had been especially active in central Europe and the Baltics, respectively. In much of central and eastern Europe, the high degree of foreign ownership, almost paradoxically,

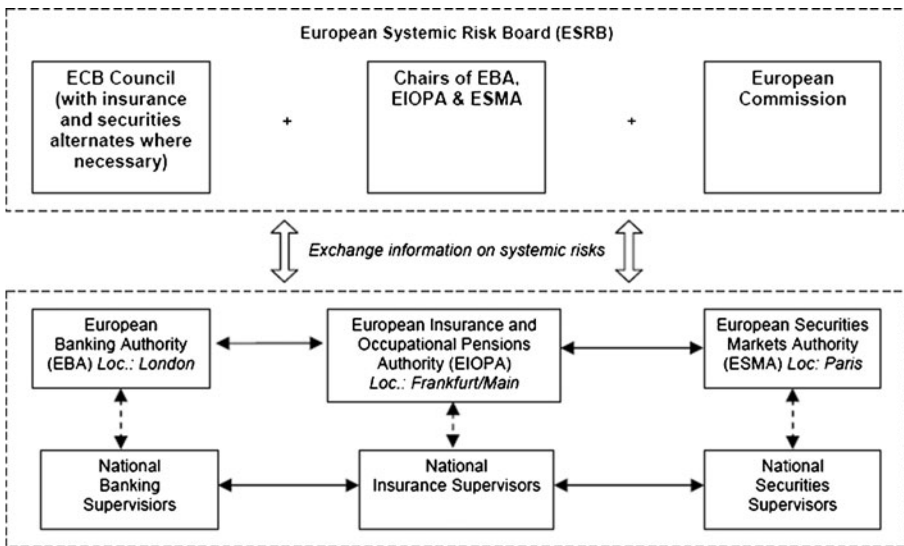

Fig. 2 The new supervisory architecture in Europe. Source: European Commission (2011)

limited exposure with the result that most of the countries were only mildly affected (Latvia being an extreme exception). During the fire-fighting phase, more than 40 financial intermediaries had to be recapitalised, requiring permission from the European Commission to overlook standard competition rules governing state aids to competitive companies.

Reform of financial regulation and supervision was immediately placed on the policy agenda and a high-level group chaired by Jacques de Larosière (2009) duly produced a report with a comprehensive plan for reforming both macro-prudential supervision—in effect, a new approach to preventing systemic problems—and the supervision of individual financial intermediaries. The main features of these reforms (Begg 2009) included a new European Systemic Risk Council (since relabelled as board, rather than council, hence ESRB) and a European System of Financial Supervisors (ESFS). After rather difficult negotiations between the Council of Ministers and the European Parliament over a number of aspects of their functioning, agreement was reached in November 2010 on the details of these new bodies and a new system became operational in January 2011. It is portrayed in Fig. 2, which shows that the ESRB will be made up of a mix of central bankers, representatives of the three sectoral European supervisory authorities and the European Commission. Its primary role will be to assess macro-prudential risk and will include monitoring of Member States budgetary positions as well as developments in the financial sector as such.

The ESFS will consist of the three EU level supervisory authorities and their respective national counterparts. The focus of the ESFS will be on micro-prudential supervision of individual financial entities. As the chart shows, there will be close concertation between the two new bodies in assessing systemic risk.

Although the sectoral European Supervisory Authorities (ESAs) will not, in general, directly supervise financial companies, on the grounds that the national authorities will be closer to their respective regulations, there are special provisions for credit ratings

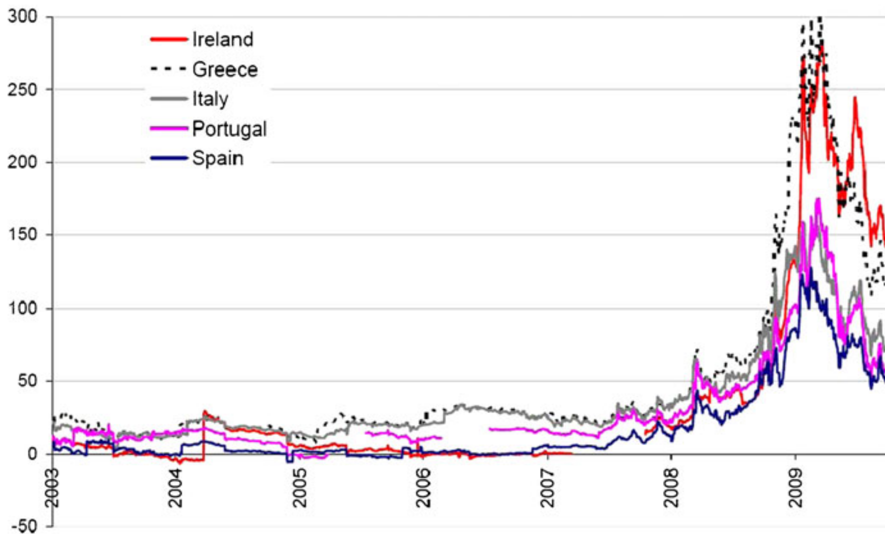

Fig. 3 Sovereign bond spreads, relative to Germany (basis points). Source: Barrios et al. 2009

agencies. Early in December 2010, the legislation setting up a new pan-European supervisory authority was agreed. It includes provisions for directly supervising credit rating agencies by the ESMA, and there is scope for fining agencies which breach rules within prescribed limits and subject to specific procedures.

Even during the period of intense financial turmoil in autumn 2008, there was little sign of the financial pressures on governments that became the sovereign debt crises, and it is only, as Fig. 3 shows, in 2009 that the markets began to demand the much higher spreads for funding the Member States now at the heart of the sovereign debt crisis.

More recent developments

Clearly, the deterioration in the euro area took policy makers by surprise. The sovereign debt crises that erupted in 2010 were, somewhat paradoxically, both predictable and unanticipated. Increasingly acute macroeconomic imbalances were evident in the run up to the financial and economic crises, but did not initially threaten sovereigns; indeed, by the summer of 2009, as the outlook for most EU-27 countries began to improve there were few signs of the storm that would subsequently engulf Greece, Ireland and Portugal, and threaten other Member States.

The responses were difficult and involved many emergency meetings, but the eventual outcome was rescue packages for Greece, Ireland, Portugal and, latterly, Greece again. This was all very fraught and exposed weaknesses in decision-making, communication with markets and understanding of the scale of the problem. Perhaps the key element was a de facto mutualisation of debt through the creation of a large fund—the European Financial Stability Facility (EFSF), but since it was hurriedly created after political decisions in 2010, it has been criticised as too small.

The relentless financial market turmoil has, however, obscured the fact that there is a steady trickle of good economic news coming from many EU countries. Even Greece, according to newly published data presented by Schmieding et al. (2011) is

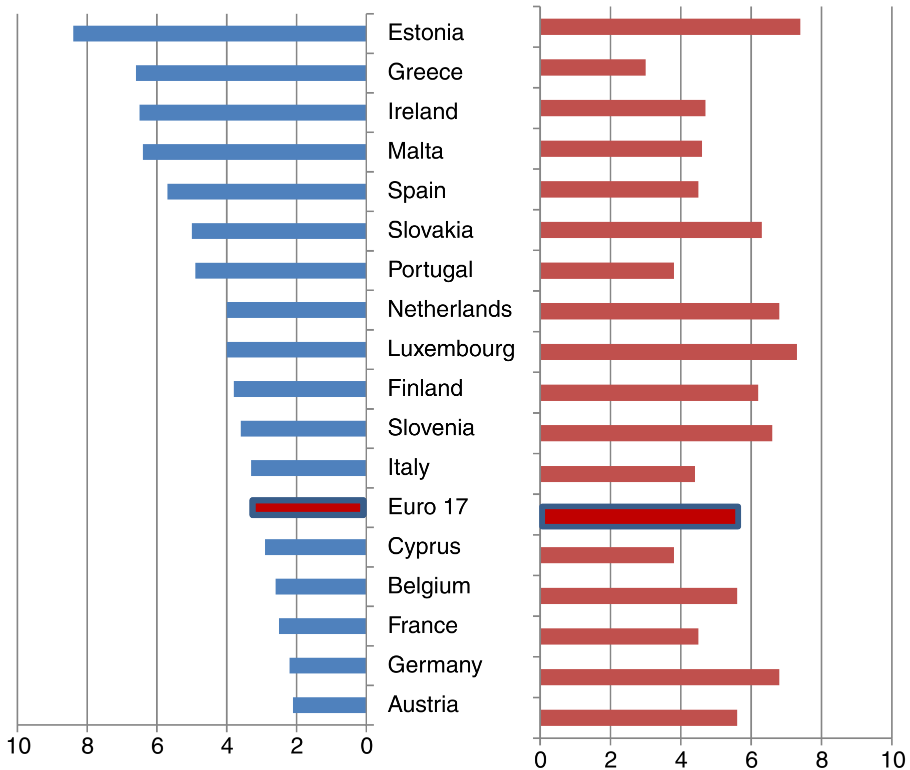

Fig. 4 Adjustment by Eurozone countries. Source: Berenberg Bank—quoted in Schmieding et al. (2011)

making tangible progress towards the sorts of adjustments it needs and is one of the EU countries to have moved most in the right direction of late—albeit from such a weak starting point, as shown in the 'health' panel of Fig. 4. Among the key trends are that:

- Domestic demand has become the main driver of the German economy, while net exports have started to increase in some of the countries in the greatest difficulty, including Greece and Spain. In fact, Greece has seen a sizeable increase in industrial orders from abroad, though from a worryingly low base.
- While part of this is simply the result of stagnation, it also reflects a rebalancing of the euro area that has been sorely needed.
- Some progress has been made on the key supply-side reforms, although clearly much needs to be done
- It can also be argued that a new realism is evident in policy-making and that the arrival of technocratic governments with a mandate to make the hard choices in both Greece and Italy—reservations about their legitimacy notwithstanding—presages a more rapid pace of change.

Table 1 Overview of budgetary discipline in EU, 1999–2007

	Surplus	Deficit 0–3%	Excessive deficit	Percentage of excess (%)
EU-15, 1999–2003 (75 observations)	29	32	14	18.7
EU-15, 2004–2007 (60 observations)	26	18	16	26.7
Sub-total EU-15 (135 observations)	55	50	30	22.2
EU-10 2004–2007 (40 observations)	6	23	11	27.5
Total EU-25 (175 observations)	61	73	41	
Percentage of cases	34.9	41.7	23.4	

Source: Own elaboration using data from AMECO database

The underlying problems

Although many of the symptoms of the crisis can be readily understood, the whole story has exposed a number of underlying problems that go to the core of what is needed to make a monetary union function. They raise awkward questions about the design of the system of governance for the EU as a whole and specifically for the euro area. Oversight of budgetary discipline under the SGP and the Broad Economic Policy Guidelines has been—rightly—criticised. However, one of the principal conclusions from the troubles that affected the euro area from the spring of 2010 onwards is that broader imbalances (both within and between countries) and divergences in competitiveness had not been given due attention. Nevertheless, fiscal discipline was lax.

For EU-15, the latest data (which incorporate revisions which, in some cases, differ from the figures used for policy purposes at the time) for the 9 years from 1999 to 2007 (before the crisis erupted, during which time there are 135 observations of annual budgets: 9 years, 15 countries) show deficits over the 3% threshold that defines 'excessive' were registered 30 times (22.2%)—see Table 1. Adding the ten new members that acceded to the Union in 2004 and taking their data for the 4 years from 2004 to 2007 yields a further 40 observations, and reveals that in only 34% of the aggregate of 175 country/year cases were surpluses recorded, despite the fact that the 2004–2007 period was an economically benign one in which fiscal consolidation should have been feasible.

These simple statistics confirm that the 'close to balance or in surplus' aspiration supposed to be at the heart of the SGP was poorly respected and the detailed data show that few countries did so with any consistency. Denmark and Finland (9 out of 9), Ireland and Luxembourg (8) and Sweden (7) were the exceptions among the older EU-15 member states, as was Estonia (4 out of 4) among the new EU-12 Member States, whereas excessive deficits were recorded in all 9 years by Greece,[2] in five out of nine by Italy, and four in Germany and Portugal. Hungary had an excessive deficit in all 4 years from 2004 to 2007. Although a majority (16 out of 27) of EU-27

[2] These data reflect revisions made since Greece was adjudged to have passed the euro entry criteria

Member States reduced public debt between 1999 and 2007, the level of debt of the euro area as a whole remained stubbornly above the 60% threshold that served as the criterion for joining the single currency. The eight Member States above the threshold in 2007 comprised three (France, Germany and Italy) of the four largest Member States and it is noteworthy that the debt ratios of France, Germany and the UK all increased between 1999 and 2007.

The rapid deterioration since 2007 is expected[3] to result in only the three Nordic countries and Luxembourg having debts below 60% in 2011 among the EU-15, whereas 9 of the EU-12 Member States pass this test. More worrying is the fact that only five of the 17 euro area members achieve the debt ratio, with seven of them (including Germany, France and Italy) projected to post debt ratios above 75% of GDP for 2011. These deficit and debt data suggest that the largest Member States have been fiscally less disciplined than a majority of the smaller ones. Because of their much greater weight in the overall EU economy, it is a matter for concern that they seem to be less inclined to follow the rules, pointing to a political challenge. It also raises the questions of why prevention was unable to anticipate the extent and speed of these deteriorations, and of whether the reforms currently being introduced can be expected to lead to better outcomes, despite being rooted in a similar approach.

Taken together, the imbalances and a number of governance gaps illustrate the shortcomings that afflicted the euro area. Thus, the very high current account deficits of Greece, Portugal and Spain should have been recognised as symptoms of imbalances that would need to be corrected by macroeconomic policy shifts to encourage higher savings, while for Latvia, the lack of sustainability of the FDI inflows that offset its high net imports ought to have been spotted—and acted upon—much sooner. The excessive credit creation by Irish banks and the effect it had on property markets were highly visible, yet were not confronted in a timely manner, either by regulatory action or by microeconomic policy changes to curb credit growth. The trouble was that flattering GDP figures (except for Portugal), allowed policy-makers to overlook the gathering storm.

The current position

Although the ECB has played a considerable part in fending off a worse crisis by adopting a series of 'unconventional measures', it has done so at some risk to the integrity of its mandate and independence. Nevertheless, it has shown that there is more latitude in monetary policy than many feared. Today, the contagion question is at the heart of much of the current round of austerity in what is essentially a trade-off. Countries that put off action risk attack from the market, driving up their costs of debt funding and raising the interest component of public expenditure by several percentage points of GDP. Acting too decisively to impose austerity can choke-off recovery and aggravate the downturn, also leading to worsening fiscal arithmetic. This war of the spreads has already claimed Portugal and Ireland, as well as Greece and has had Spain, Italy, Belgium and France in its sights. Yet the

[3] According to the Commission's autumn 2011 economic forecasts

Table 2 Current macroeconomic indicators for 2011 (projected)

	GDP growth, % GDP	Fiscal position, % GDP		External balance, % GDP	Unemployment rate, %
		Deficit	Debt		
Euro area: of which	1.5	4.1	88.0	−0.1	10.0
Germany	2.9	1.3	81.7	5.1	6.1
France	1.6	5.8	88.4	−3.2	9.8
EU27	1.6	4.7	82.5	−0.3	9.7
UK	0.7	9.4	88.8	−2.5	7.9
United States	1.6	10.0	101.0	−3.3	9.0
Japan	−0.4	7.2	210.0	2.9	4.8

Source: European Commission (2011), autumn forecasts

collective fiscal arithmetic of the euro area—while far from sound—is some way from being unsustainable. In fact, the overall deficit and debt of the euro area, as a percentage of GDP, are well below those of the US, Japan and, indeed, the UK—see Table 2, and the euro area's net external position has consistently been very close to balance.

Instead, the problem is that the current institutional configuration of the euro area emphasises the national over the collective. Imbalances between Member States certainly grew in the euro area over its first decade, yet little attention was paid to them. With hindsight, it is glaringly obvious that there was a north–south cleavage between the export success of Germany, Finland and the Netherlands and the increasingly large current deficits of the Iberian countries and Greece, with France and Italy somewhere in the middle. Ireland and Spain had property bubbles fuelled by private debt, while Greece's growth was based on a public debt bubble. A glib explanation for these developments is that the one-size-fits-all monetary policy of the euro area did not fit any, but this is only part of the story.

First, it was all too easy 4 years ago to interpret the performances of Spain and Ireland as exemplary: growth was strong but inflation was moderate, the public finances were in good shape and the warning bells about the growing share of the economy accounted for by construction did not ring very loudly, if at all. Markets were complicit to the extent that spreads among euro area countries had been falling and only started to rise again as late as 2008. Germany, if anything, was still considered up to 5 years ago to be a problem economy, even the 'sick man' of Europe. Again with hindsight, it is easy to see that trouble was brewing, but it was much harder to spot at the time.

Reform on the hoof—a complex array of changes

Economic governance is in the process of being substantially reformed as a result of the sovereign debt crisis, confirming the findings of Bordo et al. (2011) that crisis often stimulates significant governance developments. The reform and amplification of prevention agreed in the months that followed the eruption of the 'euro crisis' in

the spring of 2010 is extensive and impressive. One innovation rapidly agreed was the idea of a European semester for public finances, something that has been around for some time in the thinking of DG Ecfin of the Commission. It boils down to examination of the national budget before it is formally adopted, so that potential threats to stability can be corrected early. There is evident sensitivity about this on the part of finance ministers for two reasons: subsidiarity and the fact that any change in a budget is likely to have political as well as economic consequences.

The so-called six pack that resulted from the deliberation of a task force convened by European Council President Herman van Rompuy is an extensive set of governance reforms aimed at preventing future problems. After some minor modifications sought by the European Parliament, the regulations and directives to implement it have now been passed and it comprises:

- Reform of the SGP to increase the focus on debt and on long-run fiscal sustainability
- Broadening the scope for macroeconomic surveillance to encompass a range of macroeconomic indicators and using these as the basis for an 'alert mechanism' designed to identify imbalances likely to have damaging consequences. A new excessive imbalance procedure (EIP) is a significant innovation in prevention, designed to strengthen the surveillance machinery by establishing a mechanism similar to the Stability and Growth Pact, including have a corrective arm that includes financial sanctions.
- Closer scrutiny of structural policies to check that the Member State is making sufficient progress towards its Europe 2020 targets and is undertaking reforms that ease macro-fiscal difficulties. Country-specific recommendations would be issued
- A directive designed to oblige Member States to establish 'resilient and effective national fiscal frameworks' that will make it easier to conform to EU and euro area commitments

The weak link in all of this is the credibility of the proposed sanctions if a Member State does not comply. From a governance perspective, soft law devices (such as peer pressure or naming and shaming) are the first line of enforcement and, especially for the EIP, it is difficult to see the jump to financial sanctions being easily accepted. There is, therefore, a dilemma about whether prevention can be backed by more effective enforcement, with the possible catch-22 that the sanctions are designed not to be used. It was, after all, commonly believed that the fines envisaged in the corrective arm of the old SGP were a nuclear deterrent.

In addition, the euro area has agreed to a new crisis resolution mechanism in which a new fund—the European Stability Mechanism (ESM)—will succeed the temporary EFSF. The new mechanism will explicitly demand conditionality as part of a rescue and that some of the burden is borne by bond-holders. In short, it will be close to what the EU eventually arrived at in the agreements reached at the end of October 2011. The December 2011 European Council went further by proposing a Fiscal Pact that will, following the endorsement by all but the UK and the Czech Republic at the January 30th 2012 European Council meeting, see more rapid introduction of the ESM and its operation alongside the EFSF in the short-run, thereby adding to the firepower that the euro area can deploy.

Will it be enough?

The six pack will undoubtedly strengthen the preventative framework, while the crisis resolution mechanism fills an evident gap. Perhaps more tellingly, there is a new realism about the dangers and costs of back-sliding on the principles, processes and rules of economic governance. As so often before, however, the litmus-test of the new arrangements is delivery and will come when they are put to the test.

Three such tests will reveal whether the system is likely to be effective:

- First, whether financial sanctions are ever applied for breaches of the SGP, the enhanced surveillance of euro area members or the EIP.
- Second, whether in the event of a fine being levied, the Member State complies with it and pays. It will be a courageous finance minister who consents to signing the cheque.
- Third, whether any recommendations emerging from the European semester, notably in relation to commitments made in Europe 2020 National Reform Programmes in connection with the Fiscal Pact result in substantive changes in policy.

A complication is that unlike a fiscal deficit or public debt, both of which can readily be measured as a percentage of GDP, what constitutes an excessive imbalance is much less easy to identify conceptually or to calibrate. There is no simple threshold beyond which asset price increases become disruptive or which signal an excessive trade deficit or, indeed, surplus. A boom in construction is fine if it can be readily financed and helps to fill gaps in infrastructure or property provision, but can tip over into a damaging distortion of the economy if it goes too far or results in increasingly less viable projects being financed. Moreover, the fact that there are nearly always two sides to the imbalance (surpluses balanced by deficits; lenders offset by borrowers) means that identifying who should act to redress the imbalance cannot be straightforwardly ascertained by resort to statistical indicators. Imbalances also arise inside any country, taking a variety of forms, including inter-regional disparities, with congestion and inflationary pressures in some areas, while high unemployment and emigration characterise less competitive localities.

It is also as yet unclear whether the emerging framework has assigned a clear enough role to the ECB or has done enough to ensure that those Members States most exposed to bond-market pressures can fund their borrowing at manageable interest rate costs. The obvious concern is that the higher the spread, the more already indebted governments have to spend on debt service, crowding out other forms of public spending including possible growth-enhancing measures. The two main ways of easing this difficulty both elicit opposition. Unlike the UK, where the Bank of England has explicitly engaged in quantitative easing that allows the purchase of government debt, the ECB faces constitutional and political obstacles, with German objections especially critical. In December 2011, the ECB signalled to European banks that it would provide a cheap loan facility to enable them to purchase national bonds and this has been met with enthusiasm, as well as proving to be effective in lowering spreads. But a crucial question is whether it can have more than a one-off effect.

The second option of creating a single Eurobond, jointly guaranteed by all 17 euro area members is widely regarded as a development capable of easing the short-term strains on liquidity and offering an enduring answer for the funding of euro area governments' debt at reasonable rates. Yet Germany and other fiscally more robust

economies continue to voice strong opposition to them, citing both the moral hazard of providing easier loans to countries that have already borrowed too much and the likely risks to their own borrowing capability. The European Commission (2011) has now published a discussion paper about how such Eurobonds could be introduced so as to meet these and other objections, making a rather crass attempt to forestall German antagonism by eschewing the term Eurobonds in favour of 'Stability bonds'. While the label is unlikely to fool anyone, the paper has the merit of putting the issue firmly on the table, forcing Germany, the Netherlands and other net creditor Member States to explain why it will not work.

Why was it all so difficult, frenetic and contested?

Benjamin Franklin's well-known dictum that we must all hang together or we will most assuredly hang separately could scarcely be more apposite in looking at the EU today, but it is important to understand why collective action is so hard. The reasons for the slow response were succinctly summarised by Buti (2011) who distinguished between three categories of problems or—in the terms employed in his speech—'frictions'. Building on the points he raises, the following explanations can be distinguished:

- 'Economic' refers to the now familiar difficulties: initially the squeeze in the banking sector, then in the public sector, with a feedback loop that constituted a vicious circle; the fact that, at a deeper level, growth has not been restored, raising hard questions about the underlying model; and the extent of inter-connections which have made the spread of problems both immediate and debilitating.
- 'Political' factors include a sense that the good times of the years leading up to the crisis would rapidly be restored, that it could be seen as 'someone else's problem', with the result that collective actions were not easy to agree and implement, or even considered by those not in difficulty to be necessary. Buti notes that the relatively firm consensus on finding ways to deal with the post-Lehman banking crisis did not hold when the sovereign debt problems in the EU arose. But a further difficulty was that domestic political pressures meant that prevarication and half-heartedness were repeatedly in evidence.
- 'Institutional' frictions start from the fact that there is always a tension between the supranational and the inter-governmental in EU governance, and recent experience is that more of the key decision-making has accrued—whether by default or by design—to the heads of government through the European Council. Although Buti, as a top Commission official, would be unlikely to agree, it can also be argued that there have been weaknesses in leadership from the European institutions, and even though Herman van Rompuy has been quietly effective, his position is only a recent innovation.

Plenty of action, yet…

There is something of a paradox in the fact a large amount has been achieved, whether in crisis management and the establishment of new funds, legislative change or institutional development, yet the global image of the EU has been one of dithering

akin to Nero fiddling while Rome burns, especially since the summer of 2011. Both sides of this paradox deserve examination.

Starting with what has been achieved, it is important to stress the breadth of the measures. They presage a more comprehensive system of coordination of economic policy at EU and, above all, euro area levels, and fill the governance gap of the lack of a crisis resolution mechanism. Changes in the regulatory structures for oversight and prudential supervision are significant, and, in the European Systemic Risk Board, establish a new body which has the mandate to oversee macro-prudential risks. Collectively, these innovations should constitute a much better system for preventing macroeconomic instability, although an inevitable concern is that, as with the Stability and Growth Pact, inadequate compliance with the rules will undermine their effectiveness.

When it comes to crisis management, the extent to which the ground has shifted is also striking. The European Central Bank has found imaginative ways of channelling liquidity to beleaguered banks and sovereign borrowers while not quite breaching the treaty, the EFSF was set up and funded rapidly, and in the process seemingly inviolable principles dear to Member States such as Germany have been circumvented. Yet the other side of the paradox is, quite simply, that the crisis management has been too little, too late, too poorly communicated to markets and citizens alike, and too lacking in decisive leadership.

The leaders of the euro area, in particular, stand accused of having consistently under-estimated what was needed, with the result that the eventual bill will be much higher and the resulting legacy much worse than they need have been. It is not hard to explain why. First, the accommodation at the core of the single currency between competing standpoints, notably about whether rules were sufficient or needed to be complemented by economic government, always contained risks. Moreover, the benign macroeconomic conditions of the period up to 2008 meant that, despite repeated warnings about the need for closer political union (see, for example, de Grauwe 2006), the likely consequences remained hidden or hypothetical. Because the framework was not truly tested in its first decade, its resilience was never ascertained, yet when trouble arose, it soon became apparent that it was wanting.

Second, there has been persistent obfuscation of the distinction between crisis management and longer-term recasting of governance. Many of the reforms enacted since 2010 or in the pipeline represent genuine advances in the system of governance and promise better longer-run prevention of problems, but they are tangential to immediate crisis resolution. Third, the interplay between domestic imperatives and the collective interest of the euro area proved to be a source not only of tension and foot-dragging, but also limited the range of possible solutions. In essence, the issue is burden sharing, but it has been overlaid by obstacles specific to different contexts or historical associations, as well as by ‘red-lines’ which surface in national debates and then become exceedingly hard to cross. Germans fear of currency instability, with its echoes of Weimar and Nazism, are well known, but others include Slovak objections to the poor bailing-out rich or Finnish demands for firm collateral from the Greeks. Eurobonds are currently so reviled in Germany and other creditor countries that they cannot be mentioned.

Burden sharing and blame deflection

A further political economy consideration can be summed-up in the rhetorical question ‘who is holding whom to ransom’? Debtor countries know that if they

default, especially in a disorderly manner, it becomes a problem for creditor countries. Banks considered to be systemic have had a de facto state guarantee which has allowed them to take greater risks than they might otherwise have done because part of the risk is borne by taxpayers. In both cases, the risks are greater where the web of connections among financial intermediaries is extensive: both 'too big' and 'too connected' to fail are watchwords where this is the case. Ordinary tax payers are asked to pay for rescues while the affluent rich often have the wherewithal to avoid or evade taxes. A ransom game is also played out at an institutional level. At various points, the ECB has stepped in to provide the funding required because a lack of action by Member State governments or other institutions had led to perilous conditions. Yet as more is expected of the ECB, it faces the Catch-22 that other institutions or actors want to prevent it from accruing new powers.

Contagion is currently the worry for many at European level and here too multiple games are in play. Markets will be quick to pounce on any new signs of vulnerability or reluctance to act, suggesting that decision-makers have to act with great care in anything they propose. If anything radical is proposed, such as a Greek exit from the euro, the first question that should be asked is what will emerge from Pandora's box once it is opened? Too much external comment has, however, been predicated on incomplete and often dangerously simplistic analyses of what will follow. Thus, the (correct) analysis that a lack of competitiveness bedevils Greece leads to the prescription that the answer is a large devaluation—necessarily entailing exit from the euro. Obvious consequences such as an immediate run on Greek banks, a jump in legacy currency value of all Greek debt denominated in euros, inflation and so on are blithely assumed away. Despite talk of firewalls, the likelihood of attacks spilling over to other countries and their banking systems is high.

Most economic assessments of euro exit balance the gains from a currency depreciation as a means of achieving economic adjustment (notably by restoring competitiveness and expenditure switching in favour of net exports) against the costs of higher inflation, loss of spending power and possible wealth losses because of liabilities denominated in strong currencies.[4] It is probable that this last effect would lead to problems for the lenders in the exiting country's financial system. The main attraction of default is that it transfers the burden of adjustment from the citizens of the vulnerable country to the bond-holders. But there are many repercussions to consider and a sober cost–benefit assessment of these does not make it look attractive.

Growth undoubtedly has to return if debt is to be reduced and too little of the current debate has been about how to ensure it does. The Europe 2020 strategy has many worthwhile aims, but is another EU governance mechanism that has a chequered history. Its predecessor, the Lisbon strategy, had no shortage of vision for how the EU was meant to evolve, notably to boost international competitiveness and to promote the knowledge economy. But, in the final analysis, did it deliver much?

The repercussions for euro area unity also have to be considered. Popular antagonism in creditor countries has manifested itself in (often wholly impractical) calls to increase the homogeneity of membership, whether by reinforcing convergence or by splitting the

[4] When Latvia and Hungary came under strong pressure to depreciate their currencies in 2009, a compelling reason to resist was that a high proportion of private borrowing (notably mortgages) was denominated in Swiss francs, yen or euros so that devaluation would have led to private bankruptcies.

euro into hard and soft groups. A more tangible, though still remote danger is that the euro itself would unravel. Although there have been persistent and insistent calls for a break-up of the euro, or at least for the exit of Greece (and possibly other competitively vulnerable Member States), they have rarely been set out in terms that are wholly coherent or politically viable. Indeed, much of this is fanciful and based on decidedly shaky interpretations of the political and constitutional backdrop to European integration.

Concluding comments

The end game is still in play and the messy outcome of the December 9th European Council meeting which saw the UK marginalised and the need for a separate inter-governmental deal, agreed a few weeks later at the end of January 2012, to provide a way forward for the euro area and for up to nine other Member States prepared to go along with the arrangement creates new uncertainties. Indeed, despite (not for the first time) being hailed as a real breakthrough, the new Fiscal Pact is not much more than an acceleration of the implementation of the six pack and the new European Stability Mechanism, with some additional financial firepower through the IMF. However, an optimistic interpretation is that its political significance may be greater insofar as it reaffirms the commitment of Europe's leaders to make the euro work. As such it highlights the importance for the EU's leaders of ensuring that the political strategy is understood by other actors and properly communicated.

It is vital to distinguish between the exit from crisis and the medium and longer-term outlook for economies. The December 2011 and January 2012 summits left a number of issues unresolved, notably around the role of the European Central Bank. This may be deliberate ambiguity, effectively giving the ECB licence to continue to adopt unconventional measures, allowing political leaders in Germany, especially, to claim that a strong stability orientation remains in place. This may even be a sensible strategy for immediate crisis management, albeit one hard to sell to markets that remain sceptical. In particular, the magic ingredient of confidence will not easily be restored so long as a convincing route out of crisis is not visible.

Timing and sequencing will also be critical. The supply-side reforms that governments of the least competitive Member States need to undertake require political and fiscal support, as well as patience. These tensions are captured in Schmieding et al.'s (2011: 6) assessment of the outlook for Greece when they argue that the ‘turnaround in Greece’s underlying fiscal and competitiveness positions indicates that the wide-spread perception that Greece is a bottomless pit and that taxpayers are being asked to throw good money after bad is wrong—at least if policy makers prevent the current crisis from spiralling out of control’.

The debate around fiscal retrenchment also raises awkward questions. The resort to austerity packages is not an easy choice, but nor is a simplistic Keynesian option as readily available as some commentators assume. The EU as a whole and—although a little less so—the euro area are fairly closed economies, but most of the Member States are fairly open and some are very open, so that a unilateral fiscal stimulus will rapidly leak out of the economy, while an overdone austerity programme will create adverse spillovers for partners. However, in contrast to the federal level of government elsewhere, the EU level has no means of stimulating economies on its own. While some

token efforts were made to accelerate spending on EU regional policy, the amounts in question were not macro-economically significant, nor are the forms of expenditure of the sort that can rapidly inject demand into the economy.

The uncomfortable reality is still that the EU level does not have a stabilisation capability and can only fulfil such a role indirectly by coordinating national policies. Hence, despite the €200 billion stimulus package agreed in 2008, the EU relies, as Fig. 1 shows, on a handful of Member States. As more of them are sucked into the sovereign debt vortex, fewer remain to act either to stimulate the economy or to provide liquidity support to others, and the political resistance grows. This is a volatile cocktail.

In the short-term, the prospects for the euro area do not look great and the charge of dithering in the euro area is broadly justified. There are risks, and the new technocratic governments in Italy and Greece plainly face tough challenges in pushing through the necessary reforms of public finances and the supply-side of the economy. However, the political will to do so is striking as is the apparent desire of Germany to make the euro a success. This suggests that conditions are gradually being put in place to bring about a resolution of the sovereign debt crisis, although it would be rash to deny that there are still tricky hazards to be avoided.

In the longer term, the new system of governance should ensure both a better framework for governance and make it less likely that the imbalances and poor policy choices of the past are repeated. But there is also much that is either untested or uncertain, particularly in relation to compliance with new system. Possible problems could also arise because of cleavages in the economic governance between—above all—the 17 euro area members, the eight who are still 'out' but willing to go along with the 17, the Czechs and the UK with their isolationist stances. A related political question is whether there is any appetite for further governance changes and what these might be.

In particular, a deeper fiscal union has been canvassed as a necessary development and appeared to be what was under discussion at the fractious December 2011 summit. Such a union is likely to develop through a tighter framework of rules (fiscal union as rules) and some mutualisation of funding (funding or liquidity union), but explicit cross-border flows to finance public expenditure (a true transfer union) look to be implausible (Begg 2011). An especially contentious element of this would be genuine Eurobonds, jointly and severally guaranteed by all participating countries, but progress in this direction is stymied because the very expression 'Eurobonds' is toxic in Germany.

Yet it is hard to escape the conclusion that it is an obvious solution waiting to be adopted. Can Europe's leaders summon up the courage to overcome their doubts and those of sceptical citizens, while also navigating their way through the shark-infested waters of financial markets? If they mean what they say about safeguarding the euro, they will have to find that courage.

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