Steering Europe out of the Crisis

Turning EU integration into a positive-sum game

Loukas Tsoukalis

policy network paper

Policy Network
Third floor
11 Tufton Street
London SW1P 3QB
United Kingdom

t: +44 (0)20 7340 2200
f: +44 (0)20 7340 2211
e: info@policy-network.net

www.policy-network.net

Steering Europe out of the Crisis

Turning EU integration into a positive-sum game

Loukas Tsoukalis

About the author
Loukas Tsoukalis is president of the Hellenic Foundation for European and Foreign Policy (ELIAMEP), Athens.

Europe must avoid at all costs a prolonged double-dip recession, with the weakest members of the Eurozone leading a desperate suicide dance. The key challenges lie in balancing the burden of adjustment between creditors and debtors, regaining confidence in the irreversibility of Europe's currency union and restoring the political capacity of both national and European institutions to transform market driven democracies into democratically regulated markets

More than four years have elapsed since the bursting of a big bubble. What had begun as the biggest financial crisis of the West since the 1920s soon transformed itself into a European crisis, and a crisis of the Eurozone in particular, as markets and policymakers began to realise what a currency without a state really implies.

The crisis of the eurozone has three main components: a banking crisis and a sovereign debt crisis, which are not unique to Europe but which acquire a totally different dimension because of the high degree of interdependence between countries, plus a competitiveness component which can no longer be dealt with through currency realignments. We are still living with the consequences, including persistently low growth, high rates of unemployment, as well as a big increase in economic divergence across Europe, accompanied by the rise of populism within countries, and a gradual loss of trust between them. European solutions to Europe-wide problems have become increasingly difficult as a result.

We have learned some hard lessons in the process of trying to manage the adjustment to a post-bubble world, especially inside the Eurozone where we discovered that we had neither the institutions nor the instruments to deal with a major crisis – and some people suspected we did not have the political will either, and they bet accordingly. Economic and monetary union, as agreed at Maastricht, is a kind of postmodern construction that tried to defy the forces of gravity. With some delay, those forces of gravity are now taking their revenge.

When the financial crisis broke out, many people realised that the self regulation of financial markets had been a bad joke. Alas, it was a joke that many politicians on the centre-left had taken seriously in their effort to be modern. The cost in terms of political capital and credibility has been big, and it is still being paid. Now we know (or have just been reminded) that moral hazard, inherent in the 'too big to fail' notion, is a real problem that needs to be addressed through regulation, or more drastic measures. We have also learned through bitter experience that retail banking needs to be insulated from high risk betting. Furthermore, pay compensation for those employed in the sector may be a matter of public concern, while the way the finance industry has so far been taxed (or rather, not been taxed) raises important questions of equity. There is a difference between democratically regulated markets and market driven democracies – and we have come very close to the latter.

There is a difference between democratically regulated markets and market driven democracies – and we have come very close to the latter

Given the globalised nature of the financial sector, the effectiveness of regulation, supervision and taxation depends largely on the will and capacity to coordinate those functions at the level of the G-20, EU-27 and Euro-17. But waiting for all tax havens and offshore centres, big and small, to agree should not be used as an excuse for doing nothing in the meantime.

Although almost all agree that over-indebtedness is a key factor behind the outbreak of the crisis, multiplied several times in a world where financial markets have tended to resemble the operations of a casino, deleveraging of the public and/or private sector needs careful monitoring. There is no doubt that fiscal consolidation is required in many EU countries and further afield. Ageing populations, rapidly rising health costs and a large increase in sovereign debt burdens resulting from efforts to deal with the consequences of the crisis do not leave governments with much of a choice. Yet, there is an open question about timing and aggregation. If many countries resort to fiscal contraction while the private sector is also trying to reduce its debt exposure, the probability of ending up in a vicious circle of austerity and recession is very high. This is precisely where much of Europe's periphery and beyond finds itself today in tight fiscal and monetary conditions. Fiscal consolidation in a liquidity trap can be self-defeating, as a famous economist would have said. The ECB may be trying to ease monetary policy, but interest rates in the beleaguered countries of the South remain too high because of country risk as perceived by markets. Output lost today cannot easily be regained tomorrow. The unemployed become long-term unemployed. Economies implode and the risk of social explosion rises in the worst hit countries.

The bursting of financial bubbles leaves behind a debt overhang. History teaches us that some of it is usually written off, and some is eaten away through inflation. The sooner we draw the line between debt (public or private) that is sustainable and debt that is not, the better it will be for all concerned and also the quicker economic recovery will follow. The restructuring and recapitalisation of financial institutions is a necessary pre-condition for recovery. The moment of truth has been unduly delayed in Europe, in comparison to the United States for example, largely because of the highly decentralised nature of the European political system and the difficulties in reaching an agreement about how to distribute pain in the adjustment to a post-bubble world among debtors, bank stakeholders and taxpayers, and even more so between countries.

We know from the Bretton Woods negotiations and also from the early history of European monetary integration that it is difficult to agree on how to distribute the burden of adjustment between surplus and deficit countries in a world of fixed exchange rates. When there are no rules, the will of those with longer staying power in the game is likely to prevail. And these are usually surplus countries. In the period of European monetary integration that preceded the creation of the euro, repeated attempts were made to introduce rules that would ensure symmetry between surplus and deficit countries. Judging from experience, they seem also to have been in vain. The problem is, of course, much bigger when exchange rates are irrevocably fixed.

> We know from both Bretton Woods and the early history of European monetary integration that it is difficult to agree on how to distribute the burden of adjustment between surplus and deficit countries

Structural reforms are long overdue in many EU countries. Contrary to the expectations of those who had invested much political capital in the so-called open method of coordination, the Lisbon Strategy has not delivered much. It is not yet clear whether the strategy of Europe 2020 will fare any better. Insufficient progress in implementing reforms that had been officially endorsed at the European level matters even more for members of the Eurozone, because the exchange rate is no longer available. More flexible markets, especially the labour market, are needed for the proper functioning of a currency union. But reforms meet resistance, and we know from experience that structural reforms are politically very difficult when the economy is shrinking. In the short-term, they may also make the recession worse.

What is to be done?

While adopting rules, backed by the threat of sanctions, in order to strengthen fiscal discipline, we should also recognise that parts of Europe are already caught in a deadly trap of output and job contraction reinforced by negative expectations. We must avoid at all costs a prolonged double-dip recession, with the weakest members of the Eurozone leading what may look like a suicide dance.

Restoring confidence in the irreversability of Europe's currency union

We urgently need to restore confidence in the irreversibility of Europe's currency union: easier said than done, as the experience of recent years painfully demonstrates. This, in turn, presupposes that we design a set of conditions and measures that deal effectively with a dual problem: the fear of moral hazard prevalent in the creditor countries on the one hand, meaning that money lent to countries in difficulty may go into a bottomless pit, and the convertibility (or country) risk that has grown in debtor countries on the other, a risk translated into high interest rate premiums and fed by self sustaining market perceptions leading in turn to disintegration and the renationalisation of banking and financial sectors. A zero-sum mentality has taken over in Europe: the fear of 'transfer union' in the creditor countries hits against the perception of the EU as the policeman of austerity in the South. It risks causing a big political explosion. Meanwhile, economic divergence grows between creditor and debtor countries. European integration as a convergence machine is no longer working.

> A zero-sum mentality has taken over in Europe...The key challenge is restoring confidence in the capacity of our institutions, national as well as European, to take control of a very difficult situation

The devil lies in the detail of banking, fiscal and political union

Despite continuing differences about the appropriate mix of policies and the sequencing of measures, there is growing consensus that the survival of the euro requires a banking union, some kind of fiscal union including close and effective coordination of national policies coupled with partial and gradual mutualisation of debt, as well as further advances in terms of political union. Of course, the devil lies in the detail, and several politically difficult decisions seem to have been left for later. A European guarantee for bank deposits and the issuing of Eurobonds are among them. Economics dictates, but the political appetite is lacking. We want to be virtuous, but not yet. Perhaps, it all boils down to lack of trust: we are reluctant to deliver our side of the bargain because we are not at all sure that others will do the same. But the stakes are high and time is running out. Piecemeal or half measures prolong the crisis and make exiting from it more costly. The key challenge is about restoring confidence in the capacity of our institutions, national as well as European, to take control of an admittedly very difficult situation. It is also about restoring trust between countries and regaining the conviction that there are benefits for all in this common project.

Structural reforms, fiscal stabilisation and growth measures

We need a differentiated approach to fiscal stabilisation and different sequencing. Adjustment should not be born disproportionately by deficit countries. Some have a wider margin of manoeuvre than others, and they should be encouraged to take advantage of it. We need a different package of structural reforms, fiscal stabilisation and growth measures in Europe today, with more emphasis on growth as a necessary complement to reform and stabilisation. Growth policies should be investment-led, with particular emphasis on education and infrastructure. This requires both a national and a European component. What was agreed in June 2012 is clearly not enough.

Inequality and fairness

We also need to address the fairness/equality deficit in our countries. Before the bubble burst, inequalities had grown rapidly within many countries, especially those where the finance dominated model of capitalism was strongest. The situation has deteriorated since then, because of the large increase in unemployment. Growing inequality within our societies is undermining social cohesion and the political consequences are felt more intensely on the left side of the political spectrum. There is a strong feeling of unfairness as people recognise a small minority that became very rich while the party was on, and now the rest are being called upon to pay a heavy price in the name of adjustment. Distributional politics is back in a big way.

There is also a strong inter-generational dimension to the unequal distribution of gains and losses before and after the crisis. Having often been the 'outsiders' in dual labour markets, young people are now the principal victims of recession and the increase in unemployment in several European countries. Young people become increasingly alienated from politics. Dealing more effectively with equity concerns and offering a credible vision for the future to young people, without resorting to populism, constitutes a major political challenge today, especially for parties on the centre-left.

Distributional politics is back in a big way...There is also a strong inter-generational dimension to the unequal distribution of gains and losses before and after the crisis

Reimagining the European Globalisation Adjustment Fund

Distributional issues are the preserve of national governments, and it can only remain so. Yet, in times of declining popular support for European integration, especially among those who perceive themselves as losers from the opening of markets and more competition inside Europe and globally, we need to address this problem at EU level as well. The European Globalisation Adjustment Fund was set up with losers from globalisation in mind. It remained mostly in the domain of symbolism, although its scope, and the money spent, have increased in recent years as a result of the crisis. What about enlarging the European Globalisation Adjustment Fund's terms of reference by introducing an EU component of benefits paid to those who have become unemployed because of the crisis and with conditionality attached? It would be a redistributive and counter-cyclical measure, which would be especially significant in the context of monetary union. It would also serve as a political message addressed to those who feel left out of a Europe without borders: a good example of *intégration solidaire*. Solidarity with good measure, linked to common projects and with conditions attached, is the best we can hope for at present. We should make good use of it.

The emerging European public forum - and the 2014 elections

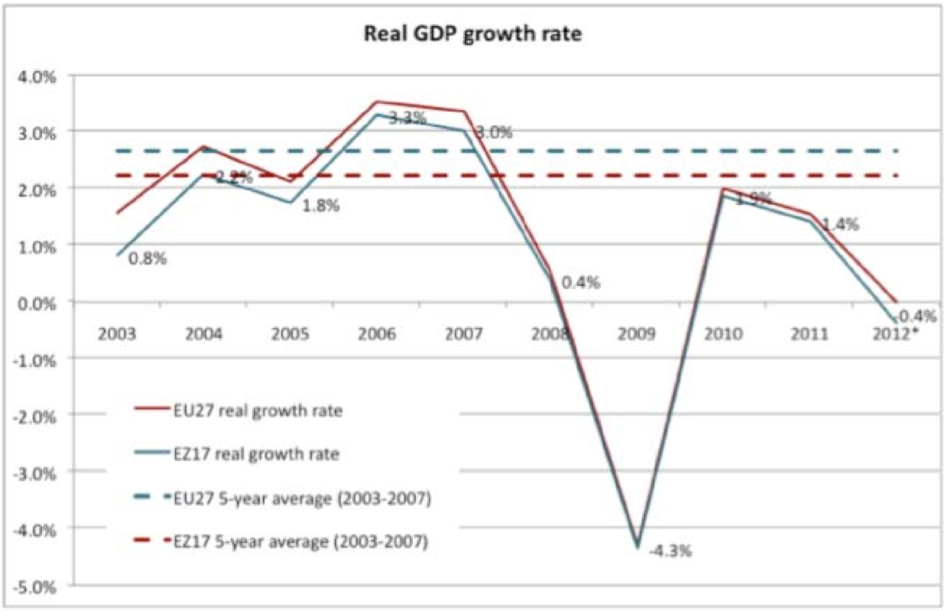
One of the few positive developments during the crisis is that it has generated a lively public debate about ways and means of dealing with it at the European level. It has not been a mere juxtaposition of national debates going on almost independently of one another and limited to a small number of *cognoscenti,* which used to be the usual pattern with EU-related issues. As with so many other debates in a democracy, it has contained elements ranging all the way from the sublime to the ridiculous and nasty. There are signs of a European public forum emerging. We should nurture it.

We need to turn European integration again into a positive-sum game. And we need institutions to match the level of market integration (not only financial markets) already reached, and those institutions cannot be created simply by fiat. They must have legitimacy that can only be gained through democratic processes. It is expected that the big political families represented in the European Parliament, including most notably the group of Socialists and Democrats, will present joint candidates for President of the European Commission at the 2014 elections. They should be people with broader appeal beyond national borders. Their selection may require thinking outside the box. The 2014 elections could be a big step in the necessary transition from policy to politics in the EU.

Loukas Tsoukalis

Appendix

Graph 1: Real GDP growth rate

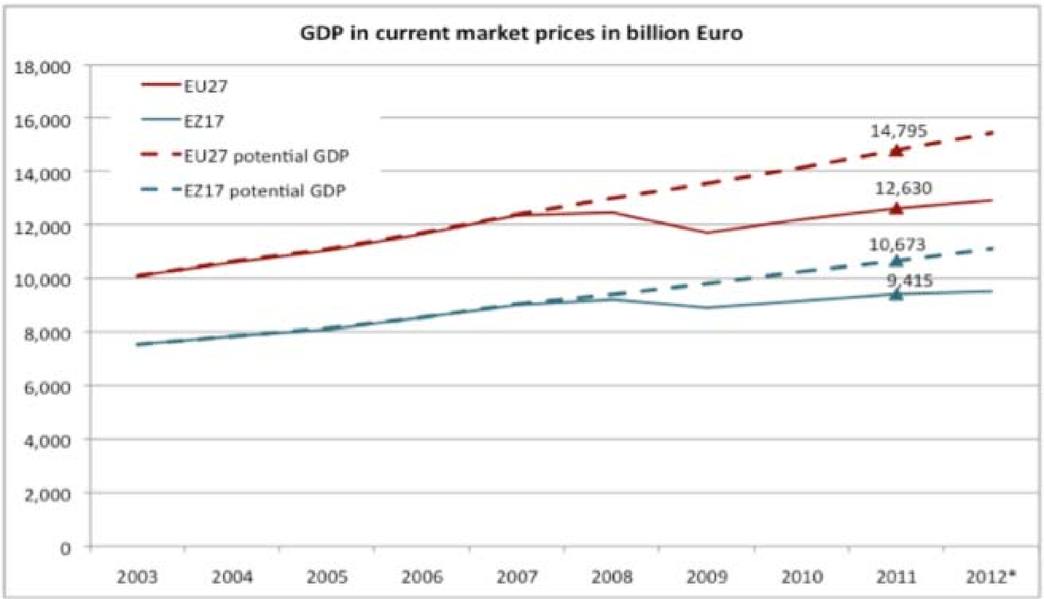


*Projections for 2012

Source of Data: Ameco Database (DG ECFIN) and own calculations

Graph 2: Loss of potential output

Compared to the 5-year average trend, the slowdown of GDP growth rates since 2008 has led to an output loss of more than two trillion euro for EU-27 and more than one trillion for the Eurozone.

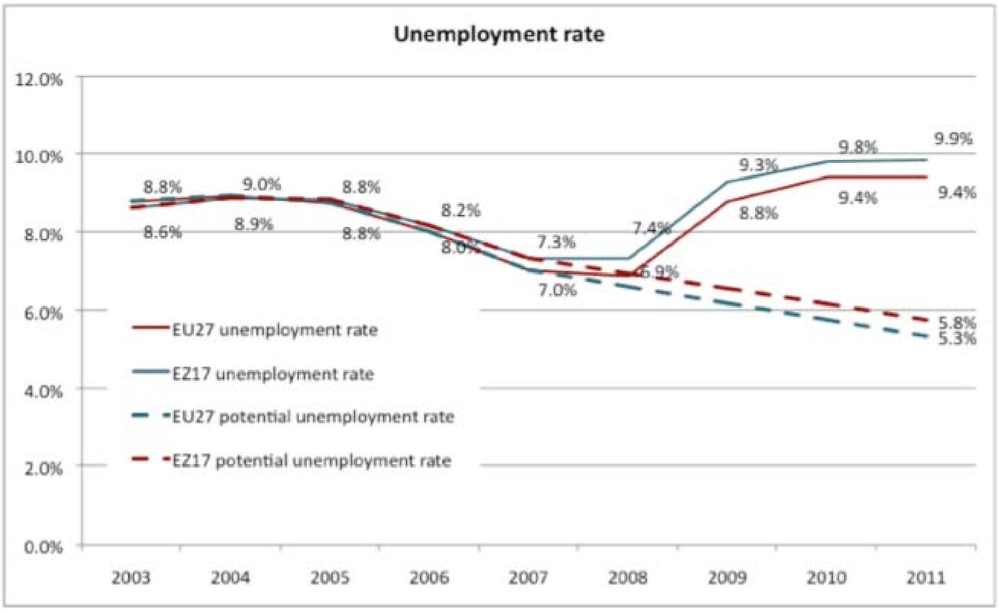


* Projections for 2012

Source of Data: Ameco Database (DG ECFIN) and own calculations

Graph 3: Unemployment rate

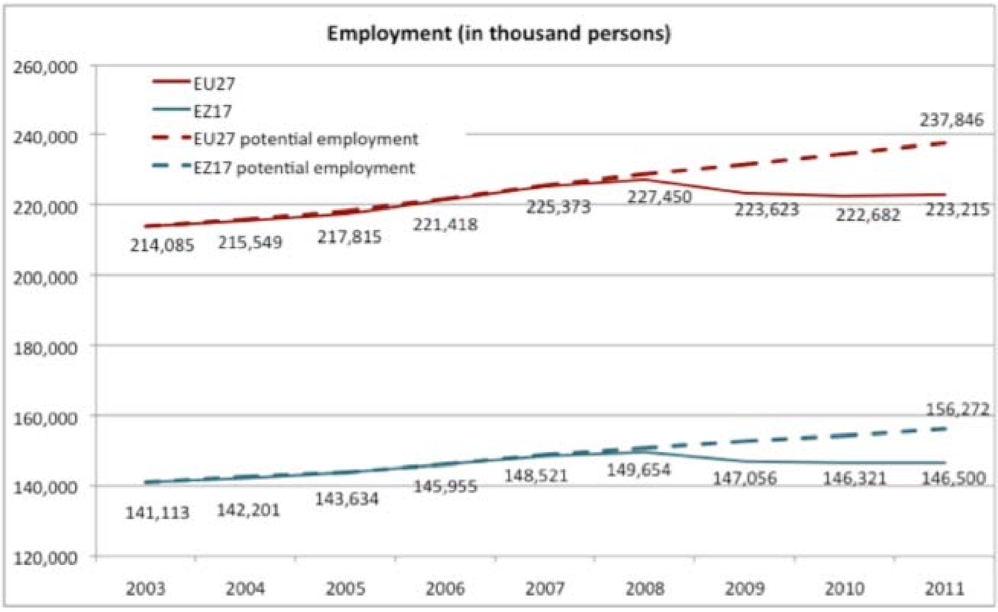
Unemployment has increased by 3 percentage points since 2008. If the EU had been able to sustain the previous 5-year average of GDP growth rate, unemployment would have been lower by more than 4 percentage points (based on an elasticity of employment to nominal GDP of 0.3).



Source of Data: Ameco Database (DG ECFIN) and own calculations

Graph 4: Loss of potential jobs

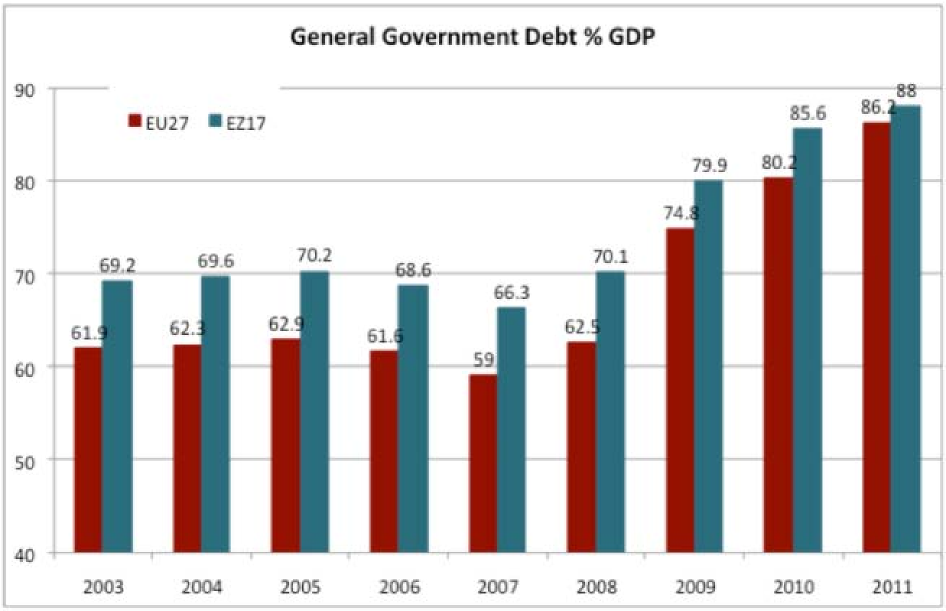
On the basis of the above calculations, the crisis may have cost more than 14 million jobs in EU-27 and 10 million jobs in the Eurozone



Source of Data: Ameco Database (DG ECFIN) and own calculations

Graph 5: Public debt as percentage of GDP

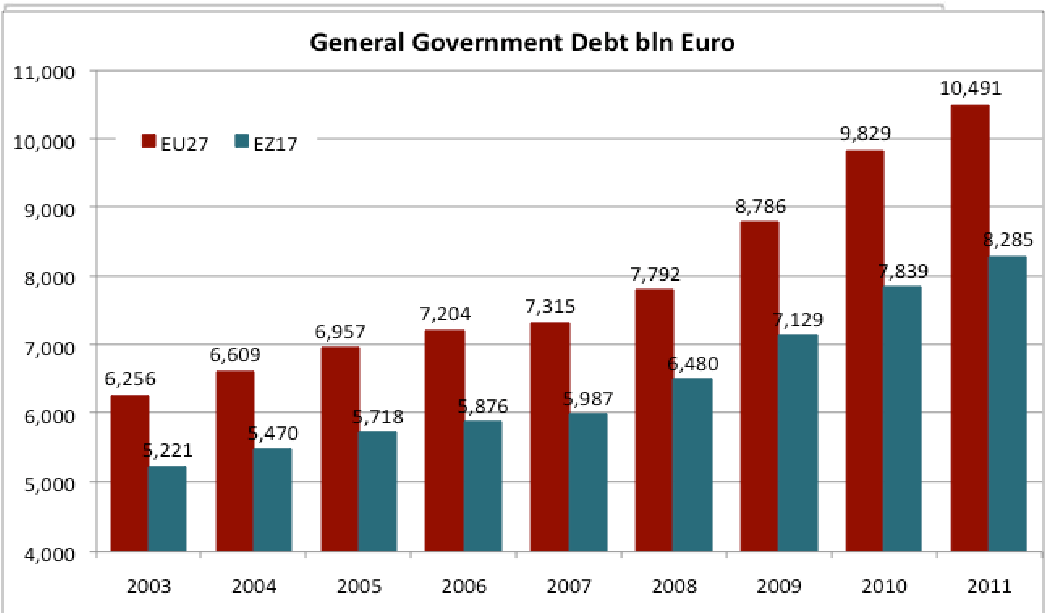
Since 2007, public debt has increased by more than 20 percentage points of GDP



Source of Data: Ameco Database (DG ECFIN)

Graph 6: Public debt in billion euro

Between 2008 and 2010, EU public debt increased by one trillion euro per year, although less so in 2011. The increase of public debt in the Eurozone has been smaller in relative terms



Source of Data: Ameco Database (DG ECFIN)