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The Opening in Burma

Larry Diamond ▪ *Hkun Htun Oo* ▪ *Min Ko Naing*
Mary Callahan ▪ *Min Zin & Brian Joseph*

Media and Democracy: The Long View

Marc F. Plattner

Mark Tessler et al. on Arab Public Opinion
Pierre Hassner on "Politics in Crisis"
Sean L. Yom & F. Gregory Gause III on Arab Monarchies
Lise Morjé Howard on Ethnocracy
Christopher Walker on the New Authoritarians

European Disintegration?

Ivan Krastev ▪ *João Carlos Espada* ▪ *Sheri Berman* ▪ *Jan Zielonka*
Alexander Graf Lambsdorff ▪ *Philippe C. Schmitter* ▪ *Loukas Tsoukalis*

European Distintegration?

MARKETS, INSTITUTIONS, AND LEGITIMACY

Loukas Tsoukalis

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Europe is going through a deep crisis, arguably the most dangerous since the foundations were laid for the European political order after the end of the Second World War. The crisis will shape the fate of Europe for years to come. Long gone is the tide of Euro-enthusiasm that helped to raise the Euro-boat at the beginning of the twenty-first century, when economic and monetary union, together with the prospect of ever more ambitious enlargement and of the transformation of the founding treaties into a constitution, were expected to lead Europe to a much higher stage of integration.

It all began with the bursting of the biggest financial bubble since the Great Depression.[1] This bubble did not have its origins in Continental Europe. The Anglo-Americans had provided the ideology and the instruments, and the rest of Europe followed with a mix of anticipation and embarrassment. When the bubble first burst in the subprime-mortgage market, an obscure segment of the U.S. financial industry, Europeans believed (or wanted to believe) that it was none of their business. Little did they know. The crisis spread rapidly to the whole financial sector, the most globalized part of the world economy. And then it spilled over to the real economy, leading to negative rates of GDP growth in North America and Europe of a kind that had not been experienced since the 1920s and 1930s. The crisis entered a new phase around the end of 2009, when markets began to realize that a sovereign-debt crisis was in the offing. The banking crisis was one side of the coin and the sovereign-debt crisis the other. Most inconveniently, they have been feeding each other. What had begun as a financial crisis of the West, only indirectly

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affecting the rest of the world, later turned into a European crisis—more specifically, a crisis of the eurozone.

Greece, despite its relatively small size, was the catalyst for the transition into this new phase. The country was suffering from three deficits: a large public deficit (on top of an already huge public debt); a large, indeed unsustainable, current-account deficit (a clear sign of a loss of competitiveness); and a credibility deficit, once it was realized that Greek politicians, more than their counterparts in other countries, had been economical with the truth and creative in their use of statistics.[2] Greece was not unique with respect to any one of these three deficits, but it surely had the worst combination of them at a time when the crisis was entering a new phase.

One may be tempted to observe that markets should have noticed the problem earlier and stopped lending to Greece and other countries on the European periphery at rates that were only marginally higher than those charged to much more financially sound countries such as Germany. True, the eurozone was a currency union, supposedly with zero sovereign risk. But a much broader issue is involved. If financial markets really were efficient and operating with perfect information, as was repeatedly claimed by the apostles of economic orthodoxy, would the capitalist world have experienced recurring bubbles with the nasty habit of causing so much collateral damage when they burst? This was not a politically correct observation to make, at least until 2008.

As the crisis gained momentum, Greece's government dithered. Meanwhile, its European partners, at first asserting that it was a problem for Greece to deal with itself, later reluctantly accepted that Greece's problem was also a problem for Europe. The country thus became a test case for both national and European crisis-response policies. Greece's domestic political system, economy, and society were "stress-tested" under the extreme conditions of economic austerity, recession, and EU-imposed reforms, while the eurozone searched for comprehensive solutions to the crisis. Although other countries soon joined the queue for European assistance, the belief that Greece was unique persisted among its EU partners for some time, or so they said repeatedly in official communiqués.

Beyond the "Unthinkables"

The crisis in the euro area has been extremely difficult to handle, and people have gradually begun to understand what the late Tommaso Padoa-Schioppa meant when he talked about a currency without a state.[3] This is where the main difference between the euro and the dollar lies. The eurozone had neither the institutions nor the instruments to deal with such a crisis. Europe's economic and monetary union (EMU) was a kind of postmodern construction that tried to defy the laws of gravity. There was a clear imbalance between its monetary and economic legs, while the political base on which it rested was shaky. Its design reflected

the economic orthodoxy prevailing at the time of its creation, as well as considerations of political feasibility. The newly created independent central bank was intended to preserve price stability and nothing else. But the weakness of the economic-coordination mechanism that was set up, not to mention the frailty of European political institutions, had more to do with what was politically feasible.[4] It took some years for the forces of gravity to begin to take their revenge.

Since the crisis in the eurozone broke out, many "unthinkables" have occurred. They include large sovereign bailouts that dare not speak their name; a "voluntary" restructuring of Greek public debt that was hardly voluntary and may not be the last, in Greece or elsewhere; huge refinancing of private banks through the European Central Bank and direct purchases of sovereign bonds in secondary markets; binding coordination procedures for national fiscal and economic policies that will take the joint management of European interdependence into new and uncharted territory; and large European firewalls, notably the European Financial Stability Facility to be followed by the European Stability Mechanism, that were not supposed to be there because of the fear of moral hazard. Most probably, there is more to come. Yet all these "unthinkables" have clearly not been enough—at least that has been the judgment of the financial markets.[5] National governments and European institutions have consistently been a few steps behind the markets. And thus the crisis goes on.

The "unthinkables" have been extremely painful politically. Europe was unprepared, the crisis is deep, and the stakes are extremely high. Faced with a crisis that has both a banking and a sovereign-debt component as part of the big bubble that prolonged unsustainable consumption levels in the West, and also with an internal-competitiveness component that is more specific to the eurozone, the Europeans have found it very hard to come up with European solutions to a problem that could not be dealt with effectively within national borders. Banking and financial interdependence have advanced a great deal inside the currency union, and this makes national solutions to the problem unfeasible—unless, of course, we are prepared to pay the big price of a drastic reversal of the integration process. In fact, this is already gradually happening as banks and others begin to hedge against national risk inside the eurozone.

One reason for the difficulties in finding European solutions has to do with wider economic divergence. Greece faces problems that are different from those of Ireland and Spain, but in the depths of the crisis all three find themselves seeking assistance from Germany, Austria, Finland, and others that are still doing relatively well. Economic divergence has increased substantially during the crisis: The periphery has been hit much more severely than the center. Combined with the rise of nationalism and populism in most countries, it risks creating an explosive mix. European solutions are also difficult to reach when mutual trust and feelings of solidarity are in decline.

As always, one of the most sensitive issues in politics is who pays the bill. Distributional matters become even more sensitive when money is expected to cross borders. This remains true of the EU despite years of integration, the high degree of interdependence, and an unprecedented sharing of sovereignty. Redistribution through the admittedly small EU budget (still representing only about 1 percent of the combined GDP of member countries) has been a key part of the grand bargain that has sustained European integration for the last twenty years or so, and it has been correctly perceived as a sign of the political maturity of the European project.

We need institutions to match the level of market integration already reached, and those institutions cannot be created simply by fiat.

Yet the distribution of pain resulting from the crisis in the eurozone requires transfers of much larger sums of money. The sums committed to Greece alone—before we add Ireland, Portugal, and, more recently, Cyprus and Spain—are a multiple of the annual EU budget. True, these mostly take the form of interest-bearing loans, but people are beginning to suspect (and fear, if they are creditors) that they may not be serviced or paid back in full in the future. It is an issue dividing member countries of the currency area, but it is also an issue between taxpayers, bank stakeholders, and those who may be candidates to join the long queues of the unemployed in Europe. No wonder there has been so much animosity over the bailouts of sovereigns and banks, as well as about the trade-offs between fiscal consolidation and growth.

What is, after all, the price that Germany and others will be prepared to pay for saving the euro? How much adjustment is the European South willing or able to make? What is the appropriate mix for European macroeconomic policy? Should banks be rescued or should some, at least, be allowed to go under? Who stands to lose the most from an eventual disintegration? These are hot political questions that are being aired in public.

One of the few good things about 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 is the usual pattern with respect to EU-related issues. The debate generated by the crisis has been both national and European; it has involved a large number of participants, including policy makers, economists, and other experts, as well as national tabloids and the ordinary citizen.[6]

The differences have been along national and ideological lines that crosscut each other and are often infused with doses of prejudice. Some of the exchanges have turned really nasty, bringing back images of "the other" that most of us hoped had been buried for good under succes-

sive layers of European integration.[7] Germans and Greeks have usually disagreed, but they have also disagreed among themselves. The intra-German debate has been one of the liveliest, with the main opposition parties criticizing Chancellor Angela Merkel for not doing enough.

The two main lines of argument in the European debate, stripped down to their essentials, go as follows:[8] One side, identified mostly (although not exclusively) with the creditors, argues that the origin of the problem is excessive borrowing, public or private, together with a loss of competitiveness. What automatically comes next is a recipe of fiscal consolidation and structural reforms. The message "Become like the Germans" is implied or even stated explicitly. Some people go further, arguing that the eurozone, as it is today with seventeen members, cannot or should not be rescued.[9] The weakest links are bound to fall off sooner or later. The euro as a single currency may not have much of a future, say the most radical among them.

The other side has in its ranks most debtors, old Keynesian economists who have now re-entered the scene after years of banishment for their "antiquated" ideas, and center-left political parties. According to the more polished version of their argument, fiscal consolidation and structural reform are indeed desirable for indebted countries that have lost their competitiveness; but when budget-deficit reduction takes place simultaneously in several countries while the private sector is also deleveraging, there is high risk of sending the economy into an austerity-recession spiral. Furthermore, experience suggests that structural reforms are politically challenging when the economy shrinks (or sinks). As for Germany as a model to follow, it is by definition impossible for all eurozone countries to run surpluses unless the United States, China, and others are ready to accommodate, which seems rather unlikely. Part of the argument between the two sides boils down to a disagreement about the distribution of the burden of adjustment between deficit and surplus countries in a currency union. This goes back to debates that took place at Bretton Woods in 1944.

Greece remains today a battleground for opposing ideas and policies regarding the handling of the crisis and the future of the euro. Despite having made huge strides in terms of fiscal consolidation and internal devaluation—though much less so in terms of structural reforms—Greece remains the weakest link in the euro chain. Its political class, now imploding under the pressure of unprecedented crisis, has resisted radical reforms, especially of the public sector, in hopes of preserving the basis of the country's clientelist system. But it may not be able to resist for much longer as it struggles to keep Greece in the eurozone.

Some among Greece's European partners believe that it is a lost cause and that it should leave the eurozone. Others want to give it another chance, either out of solidarity or fear of a possible domino effect caused by its exit. And there is an increasing number, especially on Europe's embattled periphery, who suspect that on the basis of existing

policies Greece may be lighting a path that other countries will soon have to follow—and it looks like the path to perdition.

Despite differences over the appropriate mix of policies and the sequencing of measures, a majority of economists and politicians in Europe now believe that the survival of the EMU requires a banking union, a fiscal union, and further major advances in terms of political union. In other words, we need to provide, at long last, a solution to the problem created by having a currency without a state. The old "elitist conspiracy"[10] behind European integration, with good intentions and remarkable results until recently, is being remobilized for the good old cause. Most members of this conspiracy are now older but still influential. Some are getting cold feet; others give the impression that they want to be virtuous, but perhaps not yet! They all know the task will be enormous and the opposition strong. They also know that if they succeed, some countries will be left behind, the United Kingdom certainly among them.

The crisis has turned European integration into a zero-sum or even a negative-sum game in the eyes of many of its citizens. While an increasing number of people in the creditor countries of Northern Europe have become haunted by the specter of a "transfer union," seeing themselves as subsidizing deficit countries, for those in Southern Europe the EU is perceived as the policeman of austerity, with the economic and social costs rising by the day. Support for European integration has been declining in many countries. Populist and extremist parties have been rising, and so has nationalism—often in its uglier varieties. These developments are, of course, an expression of general dissatisfaction, the main target of which is not necessarily the EU. More often than not, the effects on the EU look like collateral damage. There is anger against the bankers, alienation from establishment parties and politicians, dissatisfaction with globalization and the way that gains and losses have been distributed. The problem is certainly not unique to Europe, while the size of it varies from country to country. Many national politicians have already been sacrificed while trying to manage the crisis. Governments have fallen one after the other. Newly elected ones have been forced to abandon key elements of their electoral programs shortly after taking office, while Italy and Greece have seen nonelected technocrats elevated to the post of prime minister, although with the approval of parliament.

We seem to know what is needed to save the euro (and much of European integration with it), but politically it proves very difficult to do. The appetite for more integration is simply not there. What has kept the show on the road so far, along with new measures and further doses of integration every few months (although still deemed insufficient by markets), is the realization that the stakes are extremely high, and so would be the cost of disintegration. Fear may indeed be a strong motivation. The commitment to safeguard the euro is being constantly tested, and these tests are getting more demanding by the day.

Democracy and financial markets have always been difficult bedfellows. The relationship between them needs to be set on a new basis in Europe and globally. We have not yet heard the last word on this. In Europe, the challenge is much greater: We need institutions to match the level of market integration (not only of financial markets) already reached, and those institutions cannot be created simply by fiat. They must have legitimacy that can be gained only through democratic processes. Is Europe ready for it? This remains an open question. If the answer proves to be negative, conclusions may also have to be drawn about the sustainability of the process of globalization. After all, European integration is a kind of regional globalization, only much more advanced.

NOTES

1. For a good account of the crisis, see Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (New York: Penguin, 2010).

2. Loukas Tsoukalis, "Greece in the Euro Area: Odd Man Out, Or Precursor of Things to Come?," in William R. Cline and Guntram B. Wolff, eds., *Resolving the European Debt Crisis* (Washington, D.C.: Peterson Institute for International Economics, 2012).

3. Tommaso Padoa-Schioppa, *The Euro and Its Central Bank: Getting United After the Union* (Cambridge: MIT Press, 2004).

4. Loukas Tsoukalis, *What Kind of Europe?* 2nd ed. (Oxford: Oxford University Press, 2005).

5. For a lucid account of the euro crisis, see Paul de Grauwe, "The Governance of a Fragile Eurozone," Working Document No. 346, Centre for European Policy Studies, Brussels, May 2011; for a piece aimed at a wider public, see Jean Pisani-Ferry, *Le réveil des démons: La crise de l'euro et comment nous en sortir* (Paris: Fayard, 2011); and for a more political account, see Andrew Moravcsik, "Europe After the Crisis: How to Sustain a Common Currency," *Foreign Affairs* 91 (May–June 2012): 54–68.

6. A good part of it has been conducted in the pages of the *Financial Times.* Tabloids such as *Bild Zeitung* have also played a role, usually pouring oil onto the fire of prejudice.

7. Germany has emerged as the leading power in Europe during the crisis—its role, unavoidably perhaps, the object of much criticism. See Almut Möller and Roderick Parkes, eds., "Germany as Viewed by Other EU Member States," EPIN Paper No. 33, 21 June 2012, *www.ceps.be/book/germany-viewed-other-eu-member-states.*

8. For a clear presentation of the academic underpinnings of the policy debate, see Simon Wren-Lewis, "The Return of Schools of Thought in Macroeconomics," VoxEU.org, 24 February 2012, *www.voxeu.org/index.php?q=node/7656.*

9. Thilo Sarrazin, *Europa braucht den Euro nicht: Wie uns politisches Wunschdenken in die Krise geführt hat* (Munich: Deutsche Verlags-Anstalt, 2012).

10. This is the term that I used in *What Kind of Europe?* to argue that European integration had been essentially a top-down, elitist project, relying for years on a "permissive consensus" of European citizens that may no longer exist due to deepening integration and enlarged membership.