



ABSTRACT

This brief discusses the reasons behind the sovereign debt crisis and the policies that will impact the future of the eurozone. The construction and governance of the eurozone have come under intense scrutiny following the global financial crisis and the sovereign debt crisis in Europe. The author argues that the Stability and Growth Pact, which was poorly enforced, could not prevent the irresponsible fiscal behavior of many eurozone members. Monetary integration without common fiscal policy and political integration is thus a risky undertaking.

The financial architecture of the eurozone needs to be rebuilt so that the eurozone can return to economic growth. The European Financial Stability Facility, the Europe Plus Pact and the European Stability Mechanism are all important instruments toward this goal. But for the euro to be sustainable and stable, there is a need to fundamentally rethink the mode of economic governance in the eurozone.

EU Centre Policy Brief

Number 2, May 2011

The Remaking of the Euro: Changes to the Economic Mode of Governance of the Eurozone.

Does the Euro Still Have a Future?

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I The Stability and Growth Pact - Deficiencies and Failures

Until very recently the euro, the common currency adopted by 17 of the 27 European Union (EU) member states, was seen widely as a possible contender to the US dollar in its function as the international reserve currency. Some experts even went as far as to predict the date on which the US dollar would be overtaken. This optimism was anchored mainly in the extraordinary price stability record of the new currency that made it more attractive as a unit of account and as a store of value. It needed only a single financial crisis to change this perspective. Even then, the euro is not close to moving into a zone of price instability. The real problem the euro encounters is the permanent division of the eurozone into a group of economies with strong levels of international competitiveness and a group of debt-ridden unstable economies with weak international competitiveness.

Such a constellation is not sustainable for a currency union that came about without accompanying political integration. When the euro was launched in 1999, the founders of the common currency assumed it would be sufficient to introduce fiscal surveillance institutions that would control and eventually guarantee convergence processes of the member economies. However, this assumption was flawed, and reality hit when the financial crisis triggered potential sovereign debt crises in the periphery of the eurozone. This has highlighted that introducing a supranational currency without accompanying political integration is a risky maneuver. The policy-makers of the euro were well-alerted early on that the new currency in Europe might quickly be compromised by loose national fiscal policies as free-rider opportunities come up along the way. In particular, it was the German government that cleared the way to introduce the Stability and Growth Pact

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(SGP) as a disciplinary institution that should guarantee responsible fiscal behavior by member states within the euro zone. At its core, the SGP had a ceiling of public deficits to 3 % of GDP and additionally allowed a maximal debt level of 60% of GDP. Unfortunately, from the very start, the latter target was not strictly enforced, as it was stipulated that member economies with public debt above the 60% limit were to introduce adequate measures to move this indicator systematically towards the target limit in order to fulfill these criteria. In other words, from the very beginning surveillance agencies were not serious in actually bringing down accumulated public debt to within the target range. National interests, reflected in national fiscal policies prevailed and as a result, the SGP had a much weaker impact than planned.

Despite the political attention the SGP received, it turned out to be a toothless instrument, as it did not prevent irresponsible fiscal behaviour or sanction countries that flouted the pact. Many economies, for varying reasons, violated the public deficit target early on. Greece, Italy and Portugal were the biggest culprits. Even when using its own figures, Greece was systematically reporting above the ceiling figures for the whole period between 2000 and 2007; Italy did exactly the same; while Portugal was only slightly better off as it kept its public deficit below the ceiling in 2007. Germany had deficits above the target between 2002 and 2005; France violated the SGP in 2003 and 2004; Austria between 2004 and 2006, and the Netherlands reported a violation in 2003.¹ The situation is even worse with regard to public debt. Countries like Greece, Italy, and Belgium entered the euro zone with higher debts than the SGP allowed, and never even came close to reduce their debt piles.

However, not all economies that belonged to the group of violators ended up in the current group of potential debt default economies. Germany, for example, was violating the deficit target and achieved jointly with France, another violator, a reform of the SGP in 2005, which added a further discretionary clause to the SGP. This reform was supposed to avoid a situation where the excessive deficit procedure would eventually result in a fine, and thus not only further hurt German public finances but also put a dent into the country's excellent credit reputation. Not only was Germany successful in reordering its public finances after 2006, not least due to improvements in economic growth, but it also added a strong dose of resilience to its regime of accumulation that resulted in impressive improvements of its SGP position.

The German case shows that public finances are an integral part of the domestic economic-political regime and are handled in this domain and not in the domain provided by the SGP. Public deficits or surpluses are the outcome of a range of variables, not least dependent on tax revenues that, *ceteris paribus*, reflect the strength of economic growth. They also depend on institutional factors like the ability of states to collect taxes properly. Spain and Ireland, two other 'deviant' cases, handled their public finances, until the financial crisis of 2008, in excellent ways and not only kept their deficits below the 3% ceiling but even had years with budget surpluses. This changed dramatically with the financial crisis. Ireland had to come under the protective umbrella of the EU and Spain may soon follow.

The good deficit figures for Spain and Ireland before the crisis should not be interpreted as the result of a well-functioning SGP. The probability is high that the records would have been identical if the SGP had not existed at all. In both cases, low deficit ratios reflected the dynamics of national

¹ Figures from Eurostat 2011 (accessed 14 April 2011)

regimes of accumulation. In Ireland, economic growth was driven by a strong dose of financialisation that made Irish banks big players in financial markets, and at the same time kick-started huge investments in real estate. Economic growth in Spain was driven by low real interest rates that were the result of the one-size-fits-all monetary policy by the European Central Bank (ECB) that generated its own real estate bubble. What both cases have in common though, is that the use of international liquidity was met by extremely weak regulations on the side of national regulatory agencies. This problem was compounded by the fact that regulation of the financial sector at the European level does not exist at all - an element that those who fought for financial market liberalization in Europe did not even consider when they opened this Pandora's Box. In other words, the eurozone-wide interest rate policy of the ECB, in combination with lax regulatory practices on the national level has resulted in a fragmented European regulatory system. This led to low real interest rates that in turn drove spending behavior, mainly in favour of real estate and construction sectors in those economies. High GDP-growth rates ultimately kept public debt ratios low, and even generated budget surpluses for some years.

It is often argued that the case of Greece demonstrated how weak statistical surveillance by the EU made room for policy makers of all political shades to follow their generous spending behavior. The ongoing revisions on the side of the Socialist Greek government since 2009 underline the huge gaps in the statistical reporting system and the lack of quality data which the SGP had to rely on. Eurostat and national statistical offices already work hard to improve coherent and encompassing data collection. Emphasizing the fudging of economic data however, misses the point. Runaway public deficits occur even in economies with high statistical standards. In the case of Greece, the underlying domestic problem

has more to do with the Greek variant of capitalism that has been described as a model "for a domestic market of anti-competitive regulation, barriers to entry, relatively cheap labour and stable product demand".² Adding to these features are the hallmarks of a weak tax state, underdeveloped social security provisions and rigid labor laws, resulting in a recipe for low international competitiveness.

The reform of the SGP in 2005, pushed mainly by France and Germany, added some flexibility in allowing for special circumstances to be taken into account when assessing the deficit situation of member states. The changes opened the possibility for stricter anti-cyclical public finances but neither did they generate spending restraint in times of relatively high economic growth nor did they prepare the ground for the magnitude of deficit acceptance that came with the financial and economic crisis of 2008.

The principal flaw in the SGP was its sole focus on monetary indicators without taking into consideration other factors and variables that drive economic growth. This holds in particular with regard to the ever widening gap of current accounts in the eurozone that reflect (i) divergent developments of international competitiveness and/or (ii) out-of-bounds developments of national financial regimes. In terms of international competitiveness, the speed of divergence in the eurozone increased over time and was not even seen as a problem by its institutions. Simultaneously, private sectors in some economies used the abundance of liquidity to

² Kevin Featherstone. The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime, in: *Journal of Common Market Studies*, Vol. 49, No 2, pp. 193-217 (here p. 197). An excellent analysis of the European debt crisis is given by Erik Jones: Macroeconomic imbalances and sovereign debt markets; in: Kurt Hübner (ed): *Europe, Canada and the Comprehensive Economic and Trade Agreement*, pp. 289-305, Routledge 2011.

finance ever more risky investments and thus contributed to a strong increase in the private debt levels. When the situation emerged that private sector actors needed to deleverage and thus to retreat from contributing to economic growth, it was up to the public sector then to increase its stabilization measures and to accept rising public deficits. As a result public deficits ballooned.

It was not only the SGP but the overall financial architecture of the eurozone was also ill prepared to deal with the economic shocks of 2008-2009. In 2009, only five out of the 27 member states of the EU could report public deficit ratios below 3%. Four out of the five countries with the low deficit ratios were not members of the eurozone. This loss of fiscal control reflects the high costs of rescuing financial institutions, revenue losses due to the absolute shrinking of national GDPs, and the costs of discretionary fiscal policy packages that were needed to contain the crisis. If we take into consideration that many eurozone economies entered the financial crisis with already high debt ratios, then we have a scenario of the perfect storm.

II The Political Economy of Rebuilding the Financial Architecture

The dramatic deterioration of fiscal positions was put in the limelight when George Papakonstantinou, the Greece finance minister, announced on October 20, 2009, that the reports by the previous Conservative government on Greece's deficit ratio of 3.6% had been inaccurate and needed to be increased to 12.8 % (and this was then further increased to 13.6 %). The immediate spotlight then was on Greece, mainly due to the quick responses of rating agencies and the financial markets that asked for a strong increase in the risk premiums for Greek debt. The architecture of the eurozone was

endangered, in particular due to the surprise factor that Greece generated. Neither the eurozone institutions nor national governments were in any way prepared to deal with this challenge.

Since then, "hectic" or even "chaotic" crisis management on the side of the EU has dominated. Worst of all, the form and content of the crisis management reflected the deeply entrenched inter-governmental character of the established mode of economic governance.

That inter-governmentalism reigns and national interests dominate became obvious when the rescue package for Greece was discussed. The German centre-right coalition worked hard to delay any meaningful decision, mainly due to the fact that it feared negative repercussions from the electorate in the important political battleground of North-Rhine Westphalia. By focusing on domestic interests, the German government willingly accepted a further increase of the already high yield on 10-year and five-year Greek government debt, and thus invited financial markets to put further pressure on Greece. Only when the danger of contagion was mounting did Germany eventually give its support to the €110 billion rescue package, jointly provided and managed by the members of the eurozone (€80 billion, provided according to the respective paid-up capital shares in the ECB) and the rest coming from the IMF. The package was designed as a typical IMF stand-by program and accordingly came with tough conditionalities that need to be fulfilled in order to pay out the various credit tranches.

The Greece program however, did not help to calm financial markets; on the contrary, risk premiums for Spain, Ireland and Portugal continued to increase. Pressure from the financial markets thus triggered the next response by the eurozone members, namely the launch of the

Greece Package

€ 80 bn eurozone members
 € 30 IMF stand-by/conditionalities

EFSM

€60 bn
 EU member states
 AAA rating
 Conditional loans
 EU-IMF-ECB management
 Euribor+ 292.5 basis points
 Expiry 30 June 2013
 Council decision based on article 122
 TFEU

EFSF

€ 440 bn eurozone economies (without Greece)
 € 250 bn IMF commitment
 Effective lending capacity € 440bn
 AAA rating based on loan guarantees of members
 Loans + bond purchases on primary bond market
 Strict conditionality
 EUC-IMF-ECB management
 Euribor +247 bps + EFSF costs
 Beneficiaries: eurozone economies
 Expiry 30 June 2013
 Intergovernmental agreement

European Financial Stability Facility (EFSF) which was supposed to raise up to €440 billion provided by member states of the eurozone, €60 billion of supranational funds (European Financial Stability Mechanism, EFSM) provided by the European Commission, and up to €250 billion from the IMF. By introducing what seemed at the time an economic “Powell Doctrine” of shock and awe, the EU indeed injected new breath into the dire financial situation of Greece and the eurozone as a whole. The financial markets seemed to be temporarily satisfied with the financial rescue package by the EU and the launch of the European Financial Stability Mechanism as a whole, and pulled back on their endless pressure for a certain period of time.

Then along came Ireland. Long seen as a potential candidate to move under the umbrella of the EFSF, it needed the disclosure of quickly accumulating real estate-related losses by Irish banks. The Irish government has come to the rescue of these banks, providing encompassing guarantees to their debts in 2008, leading to great stresses on government accounts. However, the severe losses of the banks and the fear by other EU member states that any bankruptcy of these banks would have severe and even uncontrollable repercussions for their domestic

banking systems led to pressures on Ireland to accept a €85 billion support program from the EU/IMF. From this sum, €67.5 billion would come from the EU/IMF and €17.5 billion from the reserve balances of the Irish treasury and the Irish National Pension Fund. More than two-thirds should go towards the public budget, with the rest being used to recapitalize the banking sector. Like in Greece, the rescue programs come with enforced drastic austerity measures. Those pro-cyclical policies drove economic growth further into the abyss while political responses differed. In Greece social unrest dominated but was kept at bay by the government. The Irish response was a default that led to new elections (and a new government).

The EFSF (temporary fund) that was launched in 2010 would be terminated in mid-2013, and this provided the next concern. What exactly would happen if Greece and Ireland could not handle their affairs in time to return to “economic growth” by 2013? And what would be the political response on the side of the EU if Portugal and Spain needed to move under the umbrella of the EFSF? Even before the Portuguese government, under the impression of a political crisis in Portugal that led to the retreat of the government, decided to make use of the EFSF, the European Union had made its next move by establishing the

European Stability Mechanism (ESM) as the permanent successor institution to the EFSF when it terminates in 2013. The ESM is flanked by a so-called Europe Plus Pact (EPP) pushed by France and Germany that is supposed to add a structure of mutual surveillance on a broad range of economic indicators, from current account to unit wage costs. The EPP is very much in the tradition of the EU's open-method of coordination that relies on peer pressure and deliberate action, which have been perceived by some as ineffective.

ESM

Effective lending capacity €500 bn
paid-in capital by EU member states + callable
capital + guarantees

AAA rating

Loans and bond purchase on primary market
(exception)

Strict conditionality

EUC + IMF + ECB management

Funding costs + 200 bps + 100 bps for amounts
outstanding after 3 years

Beneficiaries are eurozone economies

Permanent mechanism

Treaty of eurozone members in order to
establish an intergovernmental institution

This brief summary shows that it was pressures from financial markets, particularly actions by rating agencies with their endless downgrading of European government bonds that drove the EU's management of this crisis. Pro-active crisis management cannot be observed, and thus it comes as no surprise that the debates about the coherence of the new financial architecture have not yet come to an end. Macroeconomic data from Greece indicate that the economy will not be in a position to access international capital markets as planned, by 2012. Still, the EU has not yet come forward with a plan for an orderly restructuring of Greek government bonds. This is troubling as the EU has added a further element

of risk into the 'debt game' by adding so-called Collective Action Clauses (CACs) to the new ESM. Even though those CACs would only hold for new loans after 2013, this action signals to financial markets that they have to consider haircut losses for any new credits they will hand out when the new mechanism is in place. CACs are good economic policy if a clear-cut framework of debt restructuring accompanies them.

The EU and even more so the ECB make it clear that haircuts are out of the discussion. The reason for this position is obvious, at least with regard to the ECB. The latter engaged heavily in providing liquidity for debt-troubled economies by buying 'bad' bonds. Any haircut would have negative implications for the ECB's balance sheet. The opposing view on the side of the EU has much to do with the opposition from its main member states which fear that haircuts would ultimately overstretch their own banking systems as significant amounts of troubled debts are held by their banks. Currently, the main players are trying to buy time until when the ESM can be used as the main debt crisis mechanism. Given the severe economic and political costs of the actions taken by national governments, it is questionable if this strategy will succeed.

III Will the Euro Survive?

If the history of European integration and monetary cooperation in Europe can be used to speculate about the future, there would be no doubt that the euro will survive, and may even become a stronger currency than before. European integration seems to rely on crises in order to move to the next level. The current existential crisis of the euro has already changed the institutional features of the eurozone in a way nobody would have dared to anticipate a year ago. The changes so far have been the outcome of dense negotiations between governments, with

the Commission taking a backseat. If it seemed that the Lisbon Treaty has pushed the weight towards EU institutions, then the crisis seems to have stopped this trend and national governments are back in a big way in the whole crisis management process. This holds in particular for the German government whose actions are very much determined by national preferences and the political limits set by the electorate and its highest Supreme Court.

Some observers argued that without further political integration the euro would be at risk. More political integration should not be confounded with building a federal Europe. The topic of a stronger European federal state has disappeared since the year 2000 when the German Foreign Minister Joschka Fischer tried to argue in favour of it, and circumstances dictate that this discussion will not come back anytime soon. As a matter of fact, the euro crisis has moved anti-European parties in many countries into the forefront, not only in Finland where the party of the 'True Finns' may even get into a position to block a ESFS-support program for Portugal.

Keeping the euro on track comes with enormous economic and social costs in the debtor countries with high fiscal costs for the creditor countries, not least as it is uncertain whether credits will be served and paid back at a later point in time. However, the option of non-action comes with an even higher cost, as sovereign debt defaults will have, among others, severe negative repercussions for national banking sectors, which will be in strong need of public capital injections. Even though the debates about the costs and benefits of more encompassing structures, institutions and means of economic governance are not at its end, it seems clear that core countries of the EU have already invested too much economic and political capital to risk a breakdown of the eurozone.

Deepening political integration can take various forms. In essence, it needs a domestication of the harsh forms of inter-governmentalism that the crisis brought to the forefront. Strengthening, redefining and creating truly European institutions are essential. This requires handing back the initiative as well as the responsibility for economic governance to the Commission and thus avoiding the trend towards inter-governmentalism that have been led by national interests. Small but decisive steps are asked for.

The ESM offers an opportunity to move into the right direction. This new mechanism needs to put into a position an institutional framework for orderly debt restructuring of eurozone economies. This can be done with the right to buy back public debt in the primary markets (as a rule and not as an exemption) and by offering European versions of 'Brady Bonds' that allow private loan holders to exchange (for a discount) their bonds for secure and tradable euro bonds. Such an initiative would help to put an end to the on-going game of financial markets to increase the risk premiums for government bonds of the southern core in order to reap high margins. It would also provide the EU with a policy tool that allows for an alternative debt strategy that goes beyond the current traditional debt relief packages. Actorness of the Commission requires at least a modest independent budget. The introduction of a financial transaction tax would generate sufficient funds to give the Commission financial clout and thus provide space for autonomous policy action. The haphazard reforms of the SGP need to be re-evaluated and modified in the direction of nationally diversified limits for public deficits and public debt that take into account the differences of public finances. Instead of following the strict rule-binding and one-size-fits-all approach currently in place, a case-sensitive policy is needed. The ECB should keep its independence

in determining monetary policy, but has to overcome its one-target-only constitution.

To make the euro and the eurozone sustainable requires first and foremost a drastic regime shift. Changes in the economic mode of governance have been made and more are under way. Those changes will ensure the survival of the euro though it is another story to make the euro sustainable and strong.

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The European Union Centre (EUC) in Singapore is jointly established by the National University of Singapore and Nanyang Technological University with substantial funding support from the European Union.

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