The "Greek" Crisis: Implications

The system of macroeconomic governance in the European Union (EU) needs reform. That is the clear implication of the crisis in sovereign debt markets that developed in the spring of 2010. Less clear is where the emphasis should lie in reforming European institutions, who should direct the process, and how wide the remit for reform should be. These elements depend upon a number of different factors related to what actors believe about how the crisis occurred in the first place, who is to blame, and who should be responsible for ensuring that it does not happen again. The European Union is deeply divided on these questions, both among the member states and between the member states and the principal institutions. The tension between German Chancellor Angela Merkel and European Commission President José Manuel Barroso is particularly pronounced. When the Commission published is communication on "reinforcing economic policy coordination", Merkel gave it a cold reception.[1] She admitted that much of what the Commission proposed makes sense, but argued that the Commission did not go far enough. When Merkel released her government's counter-proposal to strengthen fiscal discipline, Barroso denounced it as "naïve".[2]

These two proposals are poles apart in the debate about reforming European macroeconomic governance. The Commission proposal is comprehensive and supranational. It includes provisions to improve the coordination of macroeconomic policy in general, not just fiscal policy. It stresses the importance of monitoring competitiveness, matching fiscal positions to economic conditions and forecasts, and strengthening crisis management procedures. By contrast, the German proposal focuses more narrowly on the importance of fiscal prudence and emphasizes the role of national responsibility. It includes tougher sanctions on those countries that violate the rules for fiscal coordination, such as automatic sanctions and the withdrawal of voting rights. And it suggests that provisions be made for putting over-extended member states into a form of managed insolvency (echoing earlier calls by Germany to expel errant countries from the euro).[3]

The principal forum for this debate is the special task force on economic governance reform that was chartered by the European Council during its March 2010 economic summit. That task force is chaired by European Council President Herman van Rompuy and includes representatives from all member states (not just those that have adopted the euro). It also includes representation from the rotating presidency (Spain in the first half of 2010 and Belgium from July 1) and from the European Central Bank.[4] Although the initial goal was to have the task force report back by the end of the year, the pace of events has caused it to act more quickly. Now the goal is for the task force to report back to the European Council before the summit to be held on October 28 and 29, 2010. At

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

that point, the hope is that the European Council will be able to shift the discussion from proposal to implementation.

During the first three meetings of the Task Force, it was clear that the consensus of views lay closer to the Commission than to the German proposals. After the first meeting of the Task Force on May 21 (which was also where the German proposals were first officially presented), van Rompuy announced that the Task Force would pursue four main objectives: improved fiscal discipline, strengthened macroeconomic competitiveness, more robust crisis management, and more effective economic governance.[5] When it met again on June 6, the Task Force emphasized the importance of broad macroeconomic surveillance and the use of graduated sanctions to attract attention both to fiscal policy and to macroeconomic competitiveness early rather than waiting until things get out of hand.[6] And at its third meeting on July 12, the Task Force reiterated its concern to establish an effective early warning procedure and added that it would strengthen fiscal policy coordination by focusing more attention on outstanding public debts.[7]

In part, the success of this broader agenda is due to the remit that was given both the Commission and to the Task Force. When the European Council called for the Commission to issue its communication last March, it asked not only for a solution to the current crisis in the eurozone, but also for a mechanism to push its “Europe 2020 Agenda”, which is a revised attempt to promote economic competitiveness along the lines first drawn at the Lisbon European Council summit in March 2000. Hence, while there is agreement on the need for fiscal discipline, that agreement was always going to be couched in a broader context at the European level than might be preferred in Berlin. More specifically, however, there was little acceptance of the need to structure a managed sovereign default (and far less on the implicit prospect of de facto expulsion from the single currency).

For their part, the Germans are not coming away empty handed. Although the Commission may make headway with its proposals for more effective and tightly coordinated supervision of economic policies, this falls far short of the “economic governance” long favored by the French. The European Union will not create a separate secretariat for the countries of the eurozone; neither is it likely to engage in another round of sweeping treaty revisions. Any changes made to the treaty will only be to ensure that disciplinary and support actions are grounded in strong legal foundations. Thus, while the substantive agenda may be wider than the Germans would prefer, the institutional agenda is not.[8] Some observers believe that this combination of factors represents a new shift in the balance of power between France and Germany, with Germany finally graduating from partnership to leadership. If so, there is little reason to believe that the situation will be reversed or that the Task Force will take up a more ambitious agenda for institution-building or institutional reform.[9]

This observation about German dominance is worrying because it suggests that the European Union will not be able to agree on a first-best resolution to the crisis. The rules governing fiscal policy coordination may be strengthened, and the stability and growth

pact may be reinforced, but the eurozone will remain vulnerable nonetheless. Here it is useful to recall that Germany insisted on the stability and growth pact in the mid-1990s as a means to shore up and strengthen the excessive deficit procedure set down in the 1992 Maastricht Treaty. Then as now the emphasis lay on generating a clear sense of timing for European-level supervision and intervention, an early warning mechanism to ensure that member states could make a timely policy response, and a solemn commitment to exceed the already rigorous constraints on fiscal policy in the short term but striving to achieve a structural position close to balance or in surplus over the longer term. At the time, many overestimated the success of this strengthened commitment. They complained about the stringency of the stability and growth pact, and they worried about whether the threat of sanctions – including financial penalties – would push Europe toward a near-permanent state of fiscal austerity. Almost no one anticipated that Germany would find itself in violation of the injunction against excessive deficits, and few imagined that the member states would arrange to have the excessive deficit procedure set aside.[10]

German Chancellor Angela Merkel has made it clear that her country's role in setting aside the excessive deficit procedure and subsequently reforming the stability and growth pact was a mistake. Now she wants to redress the balance. The big question is whether it is really worth the effort. That big question can only be answered by addressing four smaller questions first.

Firstly, could stricter controls on fiscal policy have prevented the "Greek" crisis? It is difficult to give a positive answer to that question – not least because of clear evidence that Greece sought to hide the extent of its over-indebtedness. Greece sold off (or hypothecated) future income streams from user fees and other forms of taxation. It systematically understated its expenditures and over-estimated its revenues. And it did all this while under special supervisory regimes that were in many ways more intrusive than for any other country in the eurozone. European Commission proposals – since adopted by the Task Force – to emphasize debts over deficits may help to uncover some of this in the future. Greek commitments to protect the political independence of its statistical agencies may go even further. But there is nothing in this story to suggest that either a more intrusive regime or a more credible threat of sanctions would have made much of a difference. Unless there is a clear positive incentive to comply with European requirements for statistical collection and budgetary reporting, some circumvention is almost sure to occur.

For the sake of argument, though, it is possible to assume that the new system for fiscal discipline will be more effective than the one it replaced. A second question is whether tight controls on public borrowing eliminate the problem. Here again, there is little reason to be sanguine. Countries like Spain and Portugal did not have obvious fiscal problems on the scale of Greece, yet nevertheless fell into difficulty. Meanwhile, countries like Belgium and Italy were much more heavily indebted in their public accounts than Spain and Portugal, and yet fared better once the financial market turmoil hit. The explanation lies in the macroeconomic balance between savings and investment rather than in the level of public indebtedness per se. Private savings in Belgium and

Italy offset much of the borrowing on the public side in those countries; public savings in Spain and Portugal come nowhere close to offsetting private-sector indebtedness. This is why the European Commission called for greater attention to be paid to macroeconomic imbalances and national current account positions within the eurozone. The problem is that these imbalances are symmetrical; German current account surpluses are offset by southern deficits, just as German excess savings is paired with southern indebtedness. Constraints on fiscal deficits only address one small part of the larger issue. Even efforts to ensure competitiveness among the deficit countries will do little address the imbalances generated by those countries that run persistent surpluses. Hence, as Wolfgang Munchau quips, politicians how believe in the success of current reform proposals have clearly forgotten how to add up to zero.[11]

The comparison between Italy and Spain raises an interesting consideration that runs perpendicular to the current economic governance reform debate: is the solution macroeconomic, regulatory, or some combination of the two? Recent musings by IMF Chief Economist Olivier Blanchard suggest that some effort on the regulatory side might be necessary alongside any macroeconomic re-balancing of savings and investment. The logic of his argument follows from the dynamics of asset market bubbles. As savings flows from one country to the next, it tends to channel into asset markets (stocks, bonds, real estate), where it sets off a vicious cycle of rising prices and further investment. As a result, it is necessary to combine macroeconomic policy with regulatory policy, which can stabilize the growth of asset prices.[12] Italy has tight restrictions on its housing market that Spain does not; Spain suffered more than Italy as a consequence.

The member states are primarily responsible for asset market regulation. They are responsible for export-led growth strategies, national wage bargains, statistical collection and fiscal policy as well. Thus, any solution to the problem must be designed with a focus on creating positive incentives for national compliance. Governments have to want to achieve a savings investment balance; given that the member states are ultimately responsible for enforcement, it is not enough to hope they will worry about what happens if they get caught. German Chancellor Merkel may prefer to embrace austerity. Just as easily, one of her predecessors may not. Hence the fourth question: what is the best way to shape incentives? It is unlikely that a supranationally monitored and yet intergovernmentally implemented institutional framework is the answer. European macroeconomic governance is very likely to evolve in a way that will not prevent a recurrence of the "Greek" crisis in the long term. If the evidence from the Task Force is a good indication, changes to macroeconomic governance will succeed in improving the system, but they will not make it failsafe. Indeed, the system will continue to be subject to the same incentives for collective defection that undermined the stability and growth pact in the first place. This does not spell the end of Europe's economic and monetary union. The euro will survive this crisis, and it will as likely survive the next. But it does mean that Europe's experiment with monetary integration is less successful than it could be. The lasting lesson from Greece is that the euro is far from a perfect construction. So long as the political constellation remains as it is, Europe will have to learn to live with that imperfection.

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.

NOTES

1. "Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social Committee and the Committee of Regions," (Brussels: European Commission, COM(2010) 250 final, May 12, 2010).
2. The original German nine-point plan can be found in English here: http://files.droplr.com.s3.amazonaws.com/files/15728807/12QVc1.KeyProposalsEuroArea.pdf. The German federal government's announcement of the plan is available in German at: http://www.bundesregierung.de/nn_987416/Content/DE/Artikel/2010/05/2010-05-19-regierungserkl_C3_A4rung-stabilisierung-euro.html. See also Valentina Pop, "Euro is Facing 'Existential Crisis,' Merkel Says," *Euobserver.com* (May 19, 2010) http://euobserver.com/9/30103. For the European Commission's reaction, see Ian Traynor, "Angela Merkel 'Naïve' over Euro, Claims European Commission Chief," *Guardian* (May 25, 2010) http://www.guardian.co.uk/world/2010/may/25/merkel-naive-euro-barosso-eu.
3. Jack Ewing, "Merkel Urges Tougher Rules for Eurozone," *New York Times* (March 17, 2010).
4. "European Council, 25/26 March 2010, Conclusions," (Brussels: General Secretariat of the Council, EUCO 7/10, CO EUR 4, CONCL 1, March 26, 2010) p. 6.
5. "Remarks by Herman Van Rompuy, President of the European Council, Following the First Meeting of the Task Force on Economic Governance," (Brussels: European Council, The President, PCE 102/10, May 21, 2010).
6. "Remarks by Herman Van Rompuy, President of the European Council, Following the Second Meeting of the Task Force on Economic Governance," (Brussels: European Council, The President, PCE 118/10, June 7, 2010).
7. "Communiqué from Herman Van Rompuy, President of the European Council, Following the Meeting of the Task Force on Economic Governance," (Brussels: European Council, The President, PCE 161/10, July 12, 2010).
8. Ben Hall and Quentin Peel, "Europe: Adrift Amid the Rift," *Financial Times* (June 23, 2010) http://www.ft.com/cms/s/0/18115178-7f0c-11df-84a3-00144feabdc0.html.
9. Wolfgang Proisl, "Why Germany Fell out of Love with Europe," *Bruegel Essay and Lecture Series* (Brussels: Bruegel, June 2010) pp. 36-37.
10. An exception is Erik Jones, who makes the case in his concluding chapter to *The Politics of Economic and Monetary Union* that it is likely the excessive deficit procedure will be ignored if it proves inconvenient. Just over a year after the book was published, that turned out to be the case. See Erik Jones, *The Politics of Economic and Monetary Union: Integration and Idiosyncrasy* (Lanham, Va.: Rowman & Littlefield, 2002).
11. Wolfgang Munchau, "Even Eurozone Optimists are Not Optimistic," *Financial Times* (July 11, 2010) http://www.ft.com/cms/s/0/833134c6-8d14-11df-bad7-00144feab49a.html.
12. Olivier Blanchard, Giovanni Dell'Ariccia, and Paolo Mauro, "Rethinking Macroeconomic Policy," *IMF Staff Position Note* (Washington, D.C.: IMF, SPN/10/03, February 12, 2010).

The European Union Center of Excellence of the University of North Carolina at Chapel Hill is funded by the European Union to advance knowledge and understanding of the EU and its member countries.