

The European Union's Eurozone Crisis and What (not) to Do About It

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THE YEAR 2010 HAS BEEN a difficult one for the European Union. In response to the mounting pressures on Greece from the international financial markets, the EU in early May extended a €110 billion loan to save the country from sovereign default. Then, just six days later, a massive €750 billion fund was instituted to stop the contagion of Greece's sovereign debt crisis from infecting other weaker Southern European economies. It was intended to signal to the markets that the EU would cover its member-states' debts. In conjunction with this response, the European Central Bank (ECB) started buying euro-denominated government debt to help stabilize the markets. Subsequently, member-state governments agreed to allow the European statistics agency, Eurostat, to review member-states' accounts and the Commission to vet member-states' annual budgets. Moreover, all over Europe, and not just in the South, EU member-states began a coordinated move to slash their budgets in order to bring down deficits and pay down public debt. None of these initiatives was enough to satisfy the markets for long, however. By the end of November, Ireland was forced to turn to the new EU fund for a €85 billion loan, and the markets had already begun pounding Portugal as speculation mounted with regard to Spain's ability to resist.

All of these actions went far beyond what EU member-states had ever done in the past, as well as beyond (and possibly against) what was written in the EU's treaties, including the recent Lisbon Treaty, now known as the Treaty on the Functioning of the EU (TFEU). In so doing, the EU took unprecedented steps toward deeper economic and political union. These actions raise a host of questions regarding European economic consolidation, monetary policy, and political will. This article

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addresses some of these questions by considering whether the EU has the economic governance capacity needed to rise to the challenges posed by the markets; whether the economic measures taken are the right ones to promote growth while calming the markets; and whether they are sustainable politically. Here, we ask not only if European member-state leaders have the political will to deepen economic integration at a time when inward-looking politics, not to say nationalism, is on the rise, but also whether their citizens are willing to put up with drastic budget cuts at a time of rising unemployment, poverty and inequality. If the answers to any of these questions are in the negative, the prospects for the euro and for deeper economic integration may be very grim indeed, with Europe itself likely to face hard times economically as well as politically.

The Built-in Obstacles to EU Action

None of the actions taken already were easy for the EU, which started out as a regional trade association over 50 years ago, but has become much more than that. It is the first region-state, meaning a regional union of nation-states which have over the years pooled together more and more areas of sovereignty, eliminated most of their internal borders as they massively extended their external ones through new memberships, and merged their markets. They also developed common policies in such domains as the environment, gender, and human rights, built a multi-level and multi-form set of governance institutions, and sought to democratize the EU. At the same time, they kept their nation-state identities, maintained national political systems, retained different social systems, and continued diverse models of economic competitiveness and growth.¹

The EU has an extremely complex decision-making system with multiple institutional actors and a dizzying array of governance processes. Therefore, taking any steps in response to the sovereign debt default crisis is difficult not just because of uncertainty over the best course of action but also because of the sheer number of actors from whom agreement was necessary. Moreover, this was uncharted territory in terms of the rules that applied. Some articles in the TFEU explicitly prohibit the kinds of actions that the EU was contemplating, such as the no-bailout clause that forbids the EU and any member-state from assuming the financial commitments or liabilities of any other, the stipulation that financial assistance can be granted only where its difficulties are caused by “natural disasters or exceptional occurrences beyond its control,” and the rule that the ECB is not allowed to purchase the debt instruments of its member-states, including government bonds. Other decision-making processes, such as the unanimity rule for treaties, make it very difficult to reach consensus and always leave open the possibility of veto from any one of the

27 member-states.

With all of these possible obstacles to action, one needs to credit the EU with a lot of imagination in its response to the crisis. With Greece, the EU skirted the no-bailout clause by making a loan at close to market prices. The EU did, however, justify the loan guarantee mechanism for the Southern European countries by interpreting the contagion from the Greek crisis as involving an “unnatural” disaster beyond the control of the member-states in question. But it did not attempt to set the mechanism up under the unanimity rules of treaties or of the European Council, for fear of failing to achieve unanimity. Instead, it agreed to set up the largest part of the three-year loan package (€440 billion) as a “special purpose vehicle” outside the treaties, now called the European Financial Stability Facility (EFSF), through multiple bilateral agreements, to which eurozone members plus Sweden and Poland signed up. The agreement in November 2010 to establish a permanent European Stability Mechanism through a treaty amendment when the temporary EFSF ends in 2013 is a big gamble, given the difficulties stemming from the need for unanimity.² Finally, the ECB got around the prohibition against directly buying government debt by purchasing it on the secondary markets.

Crisis Response and Aftermath

The obstacles to EU action help to explain why this great leap forward in European integration was anything but a model of leadership: action came at the very last minute after much hesitation and tremendous delay—largely because of German resistance—and offered only temporary relief. Had the rescue arrived in February, when the Greek crisis first arose, or even in March—to push the Greek government to try to remedy the situation through its own austerity measures—rather than May, the markets might have been reassured and the EU may not even have had to come up with the collateral loan mechanism for the other Southern European countries. This said, early resolution to the Greek meltdown might have only briefly put off the attack on the other weak economies, infamously named the PIIGS (Portugal, Ireland, Italy, Greece, and Spain).³ Once the markets became concerned about insolvency following the problems with Dubai in 2009, it was only a matter of time before the eurozone’s weaker member-states with less competitiveness and higher deficits would become a target. Greece’s deficit was at 13.6 percent of GDP in 2009⁴ while Ireland stood at 14.3 percent of GDP in 2009 and 12 percent by the end of 2010, not counting the bank debt that brought it up to an estimated 32 percent. Spain was only slightly lower, at 11.2 percent in 2009, expected to decline to 9.8 in 2010. As for debt, Greece’s debt in 2009 was 115.1 percent⁵ while Italy’s came in at 118 percent of GDP in 2010.

Given these figures, and the markets' new concerns about sovereign debt default, it is clear that there was a great need for some kind of collateral loan guarantee mechanism or financial lending institution of last resort—or a European Monetary Fund equivalent of the IMF—to deal with the problem. But it would have actually been even better had a European Monetary Fund covering the entire EU been set up much sooner, arguably when the Central and Eastern European countries were in danger of default in 2008. Had the EU signaled to the markets then that it would take care of its own member-states rather than send them to the IMF, it might have been able to avoid the whole sovereign debt problem in the first place. Instead, the member-states retained the principle of every man for himself, refusing to create a bailout for the Eastern European countries in response to the *cri de coeur* of the Hungarian prime minister against the creation of a new “economic iron curtain.”⁶ There were many good reasons for not doing so at the time, of course. These included the difficulty of quickly setting up such a mechanism, the lack of EU expertise compared to the decades of IMF experience, the concern that setting up a European equivalent to the IMF would undermine the latter, and the sentiment that it would be better to let the IMF be the scapegoat for the restrictive measures imposed on the EU member-states in need. The refrain that was most repeated, however, was that an EU solution would create “moral hazard” if countries believed they would be bailed out for their bad debts and overspending.

These concerns seem plausible. However, leaving the bailout to the IMF instead created a market hazard, with the development of an entire market betting against the EU rescue of any of its member-states from sovereign debt default. It also led to tremendous hardship for the Eastern European countries that went to the IMF for help. The EU is to blame for the hardship, not the IMF. The severe austerity regimes with radical budget deficit reduction that were imposed on Hungary, Latvia, and Romania came at EU insistence—as a European “rescue of the Washington consensus”—and against the IMF's initial more pro-cyclical recommendations, which also included giving up the peg to the euro.⁷ By heeding the Commission's advice, these countries could not solve their problems by devaluing their currencies in order to grow their way out of recession via less expensive exports and lower comparative labor costs. Instead, they had to cut spending in the public sector, closing schools and hospitals, reducing public sector salaries and pensions, as well as raise taxes. Latvia's growth rate plunged by 18 percentage points in 2009 from the previous year. Thus, at a time when the rest of Europe, and in particular the wealthier countries, was encouraged to spend significantly to avoid recession and maintain employment, Eastern European countries in trouble were plunged into deepening recessions and rising unemployment.

Eurozone members were seen to be another matter from the very start. The ECB itself proclaimed early on in the Greek crisis that it would not go to the IMF, as a matter of the eurozone's credibility to be protected at all costs. Though, it was also a matter of pride. In the end, however, pragmatism ruled, and the IMF became part of the Greek bailout, but as a junior partner (of the €110 billion loan, €30 billion came from the IMF), as it was with the loan guarantee fund (at €250 billion to the EU's €500 billion—€440 of which came in the form of the newly established EFSF and €60 in the long-standing rapid reaction stabilization fund). In the Irish bailout, the EU also contributed the largest amount of funding.⁸ This is in contrast to the bailout of Eastern Europe, for which the EU was the minor partner (with €50 billion in its rapid reaction stabilization fund), even though it largely called the shots.

The remaining question was what to do in the long term, given that the EFSF was only a temporary loan facility due to expire in 2013. Whereas most of the member-states seemed to be in support of simply making the EFSF permanent, Germany insisted on a treaty amendment for any permanent sovereign debt resolution mechanism.⁹ By mid-October, it had enlisted France's support in exchange for giving up on its call for automatic sanctions on member-states that had repeatedly exceeded the euro's Stability and Growth Pact criteria and for agreeing to France's insistence that countries be dealt with "politically," on a case-by-case basis. The European Stability Mechanism (ESM), agreed in principle by late October in the European Council, was to be a default resolution fund to which a country in trouble could turn for relief and in which the bank creditors would also be expected to share the pain. This latter move was made because, as Chancellor Merkel argued, it was not fair that only taxpayers were asked to pay for the bad debts of the banks. But rather than calming the markets when the ESM was announced, the markets intensified their pressure on Ireland and on other Southern European countries. Interest rates on bonds skyrocketed as the specter of default was raised explicitly for the first time, fueled by confusion as to whether current bondholders would also be held to account. No amount of subsequent reassurances by European leaders that "haircuts" for creditors would apply only to bonds emitted after 2013 could stop the run on Ireland, however. And by the end of November, Ireland very reluctantly turned to the EFSF, while Spain announced yet another round of painful budget cuts to fend off the markets and Portugal had voted in a highly restrictive 2011 austerity budget.

Is Fiscal Consolidation the Route to Growth?

The crisis in the eurozone brought about a new and major round of budget cutting, this time for the EU's West European member-states. Beginning in May 2010, Greece under EU prescription, then the other Southern European countries under EU

pressure prepared to engage in the same recession-promoting, growth-destroying economic exercise as that undergone by the CEECs in trouble, with the additional risk of political instability and civil unrest. In November, Ireland, having already instituted severe austerity budgets since 2008, prepared for even harsher measures under the watchful eyes of EU and IMF officials in exchange for its loan at a high rate of interest, at 6 percent—but still lower than that which the markets were demanding just before the bail-out. The Greek and Irish rescues from the risks of sovereign debt default will do a lot for the German and French banks that hold that debt, in particular through the bank consolidation program in Ireland and the anti-corruption and tax collection campaigns in Greece. However, none of this will do much for citizens who will lose their jobs from cuts in public sector jobs and public contracts to private sector firms along with their benefits from cuts to social assistance and services. The most optimistic projections for Greece suggest that the austerity measures designed to bring the deficit down to 3 percent by 2014 will push the country into recession for at least two years, with the IMF reportedly believing that it will take ten years for Greece to recover.¹⁰ The projections are somewhat more optimistic for Ireland, but only if growth were somehow to pick up despite the massive growth-destroying cuts.

It should therefore come as no surprise that although the value of the euro in the currency markets bounced back briefly in response to the loan guarantee instrument, it quickly declined again on worries not so much about whether Southern European countries would stick to budgetary austerity, but rather about what such austerity would do to European growth generally. By mid-May, from a high of \$1.60 to the dollar, the euro had hit a four year low with the dollar at \$1.23; by early June, it had slid further, to \$1.19, below the purchasing power parity of around \$1.20. And although the euro has climbed since then, this is due more to the decline of the dollar following the Federal Reserve's quantitative easing (i.e., printing money), which effectively devalued the dollar against the euro. The markets, as everyone kept repeating, seemed to want the EU to square the circle, by generating growth at the same time that it was pushing errant member-states into budget-cutting recession.

The big question for the EU, then, is how to promote growth. The experts are divided: while some prefer consolidation of finances through budgetary austerity measures that cut deficits fast, arguing that it will in the end produce stability plus growth, others insist that such policies will choke off growth, force recovering economies into recession, and push the eurozone into the kind of deflation that plagued Japan for over a decade. Whereas the latter, pro-growth experts propose continued accommodating monetary policy (lower interest rates) or even quantitative easing, modest inflation, and moderate cuts over a longer term to promote growth,¹¹ the former, pro-consolidation experts insist that these policies are inflationary, leading

to spiraling deficits and debts that will spook the markets and lead to a further run on the euro. By mid-June, the fiscal hawks had clearly won out against the doves, as evidenced both in pronouncements in the G20 meeting and in the EU.

In early June, European member-states began generalizing the budget cutting beyond the Southern European countries. Chancellor Angela Merkel in Germany, for example, announced cuts of €80 billion by 2014, the biggest in postwar history, to set an example for the rest of Europe. This was despite the fact that Germany was already a model for Europe with its comparatively low deficit of 3.3 percent, its debt of 73 percent, and its return to export-led growth. In doing so, moreover, it ignored the pleas of fellow member-states, in particular France, to stimulate domestic spending in order to help lift growth across the eurozone. The new British prime minister, David Cameron, also announced major budgetary cuts, and with better reason, given a worrisome deficit of 11.4 percent of GDP in 2009—above that of Spain—although the public debt of 68.1 percent of GDP was below the EU average and had the longest maturity of any member-state, at 14 years.¹²

The EU Commission, moreover, spurred in particular by Germany, sought to reinforce the restrictive numerical targets of the Stability and Growth Pact (SGP)—no more than 3 percent deficit, debt approaching 60 percent or below, and low inflation of no more than 1.5 percentage points above the three best performing member-states (generally 2 percent)—that countries have honored more in the breach. They argued that this was the recipe for maintaining the credibility of the euro while promoting the growth of the European economy. With regard to growth, however, the jury is still out, since even before the crisis, ever since 2003, European growth has been anemic, at around 1 percent, with prospects for long-term growth under 2 percent according to the Organization for Economic Cooperation and Development.

As for credibility, the original numerical targets of the SGP were set in response to the need to launch a new currency and the absence of any shared economic governance. These targets were made highly restrictive at German leaders' insistence, worried as they were about Italy's discipline once it entered the euro and concerned about the euro's unpopularity with the German public. As it turns out, the euro became credible, if a little battered on occasion, despite the fact that no member-state maintained the discipline, including Germany and France, not to mention Italy or Greece. This was mainly because of positive market perceptions of ECB monetary governance and of the economic fundamentals of the eurozone countries as a whole. It is important to remember that the problem for Europe started not with public debt; governments with the exception of Greece were for the most part fiscally responsible throughout this period, while Spain actually reduced its public debts significantly. Rather, it came from private debt (of household and financial institutions)—such as

the housing bubbles in the UK, Ireland, and Spain or the euro-denominated loans to East Europeans from West European banks—and the crisis sparked by banks' losses in the US subprime markets, the meltdown of the unregulated Icelandic banks, or downright malfeasance, as in the Madoff disaster. This is what governments then made public through loans, guarantees, and outright nationalization of the banks in their efforts to avoid catastrophe.¹³ As a result, national publics are being made to pay for the excesses of bankers and the failures of government regulation.

Imposing highly restrictive budgets across European countries, let alone other draconian measures—such as withholding EU funding from profligate members who disobey the rules, as Germany had initially proposed—are likely to do little to solve the problems related to the crisis, since the spillover effects are likely to punish all European citizens, including Germans, with sluggish growth and depressed consumption for years to come. Rather than recessionary macroeconomic policies, what the European countries need is to find new ways of thinking about macroeconomic governance for the EU as a whole. But the Commission, the EU Council President, and Germany remained stuck on the automaticity of SGP criteria—at least at first—and on belt-tightening, whatever the costs. Wolfgang Münchau has described the problem as one of a “small state in an open economy” mentality, which assumes that all one can do to improve competitiveness is to engage in fiscal and wage restraint.¹⁴ Only France, he suggested, has a big state mentality with a sense of the need to spur growth, even if this means a bit of inflation and deeper European economic governance.¹⁵

How the EU Could Promote Growth

So, at a time when the markets are able to shift their concerns from stability to growth, why should not the masters of the euro? This is not to say that the EU should therefore abandon concerted efforts to follow common rules of sound finance or the stability called for in the Treaty on the Functioning of the European Union. Rather, the EU needs to find a more flexible approach to economic governance, one that gets beyond the Stability and Growth Pact dogma, takes into account the big differences among its member-states' models of growth and competitiveness, and addresses the specific weaknesses in the different countries. This requires a much more finely-tuned economic governance that focuses on the micro as well as macroeconomic issues while also paying attention to questions of social justice. If the EU's announced commitment to social solidarity in its concept of “Social Europe” is to be taken seriously and if such thorough-going economic reform is to be palatable to citizens, these measures must be taken.

The EU has in fact pledged to do some of this already. With regard to the EU's

economic governance, for one, instead of evaluating countries separately on a narrow range of numerical macroeconomic indicators, the EU has agreed to consider the interplay of all the member-states' economies as part of the new "European Semester." This is a new exercise in which member-states' economies are to be assessed in advance of government budget proposals in order to provide national parliaments with an outside source of expert recommendations as they assess government budgets. Those things taken into consideration in the overall exercise would not only be member-states' economic performance but also their impact on fellow member-states, including current account surpluses and deficits. The issue of surpluses has been a contentious matter, however, since it mainly concerns Germany's surplus, which was caused by a low level of domestic consumption and a high level of exports (not just goods but also bank credit) to high consuming, low exporting EU neighbors. The German government has responded vigorously to any criticism—first raised by France at the outset of the crisis, that it needed to spur demand and reduce savings—insisting that the problem was not Germany's surpluses but the Southern European countries' deficits. In fact, both are to blame. Once the Southern European countries (and Ireland) were in the eurozone, their banks had easy access to huge sums from the international financial markets with little exchange rate risk at low interest rates and little regulation, so they lent large amounts to prominent developers. German banks were some of the biggest lenders, since they needed some outlet for the unspent savings of German citizens that they held on deposit, given comparatively little demand in the country for loans, especially by contrast with the PIIGS.

In assessing the economic performance of EU member-states, the EU Commission would be well-advised to go beyond the macro-economic criteria of the Stability and Growth Pact by taking into account how different its member-states are in terms of economic profile and how they achieve growth. With regard to economic profile, some member-states have a comparative advantage in manufacturing, such as Germany, Italy, the Netherlands, Belgium, Luxembourg, Sweden, Finland, Ireland, and Slovakia. Many of the East European countries, on the other hand, are building their manufacturing capacity, such as the Czech Republic, Hungary, and Poland. Others have greater strength in services, including the UK (in financial services), Spain and Portugal (in tourism), and France with a mix of services including tourism and finance.

Moreover, in the coordinated capitalism of Northern Europe, growth is spurred by exports of high value-added manufacturing and underpinned by corporatist relations in which highly skilled, high paid labor cooperates with management on wage restraint to maintain competitiveness and high levels of productivity. In

the liberal capitalism of Anglophone Europe, growth has been fueled instead by more flexible labor markets divided between highly skilled, high paid workers and low skilled, low paid workers; and by the more prominent financial markets that have generated a credit boom have produced highly indebted homeowners buying cheap Chinese imports.¹⁶ In the state-influenced capitalism of France and Southern European countries, growth has been enhanced (or hindered) by the greater role played by the state in promoting business, such as in arranging mergers, fighting off acquisitions, or organizing labor relations and setting working conditions. This is accomplished through measures like the social pacts of Spain and Italy or through France's 35 hour work week.¹⁷

Additional differences result from the configuration of national welfare states, which occurs between the low level of benefits and services of liberal Anglophone welfare states and the more coordinated economies. These economies themselves divide into the conservative social systems of continental European countries with reasonably generous benefits and a low level of services and the social-democratic Nordic countries, with high tax-funded, high-quality public services and highly generous benefits. These differ even more in state-influenced economies, since France approaches the social-democratic Nordic countries in public services and the conservative continental ones in benefits that are far more generous than in Southern Europe, where the family is expected to provide the missing services.¹⁸

Central and Eastern Europe does not quite fit any of these Western European varieties of capitalism. These "dependent market economies" are largely driven by outside forces, whether capital coming from global as much as European sources or regulation coming from the EU.¹⁹ Growth tends to be fueled by manufacturing, as in coordinated Northern Europe, and is underpinned by quasi-corporatist labor-management relations in which management tends to dominate weaker labor, in particular in sectors where foreign multinationals (often from Northern Europe) are predominant. The state's influence is stronger in these areas not because it exercises significant leadership but because societal interests and organizations tend to be weak and, in some cases, seriously corrupt, particularly in Bulgaria and Romania. And although there is great diversity in welfare provisions, most Central and Eastern European countries tend to resemble a somewhat less generous version of the Continental welfare state, in particular with regard to pensions and social services, with the result that the family has generally taken over from the state. Where there is no family to supplement meager incomes, poverty is the outcome.²⁰

What Kind of EU Oversight?

To do a proper job in evaluating countries in view of recommendations on how to

improve competitiveness and growth in times of fiscal consolidation, then, the EU Commission would need to take into account the very different challenges facing the member-states. This could entail setting more flexible targets with more realistic dates for debt and deficit reduction as well as considering more country-specific ways of getting there. The Commission could and should evaluate those prospects by considering the full range of economic factors that make for growth and stability: productivity, unit labor costs, employment rates, configuration of labor markets including the ratio of insiders (protected unionized workers) to outsiders, consumption, deficits, business profile, corruption, ease of doing business, and current account surpluses. Across the board cuts, which is what most Southern European member-states have been engaged in, will do little to address the real obstacles to growth.

The European Semester is definitely a step in the right direction for the EU. But what criteria will be taken into account when assessing competitiveness and how strictly or flexibly those criteria will be applied remains open, as does whether the exercise will result in an on-going economic governance system of a kind suitable for an entity like the EU “region-state,” equivalent in size and economic power to the United States in the world economy.

For real economic governance, the EU would need to create an ongoing process of macroeconomic policy formation, tied to the budgetary cycle, as national governments normally do. The process could be structured as follows: on a yearly basis, the Commission, after wide consultation, would propose overall macroeconomic guidelines that the Council would then debate and decide in discussion with the European Central Bank and in consultation with the European Parliament (which could itself use the procedure of consultation with national parliaments introduced in the Lisbon Treaty). The resulting guidelines could then be translated into more refined recommendations for individual member-states by the Commission on the basis of member-state governments’ proposed budgets, which national parliaments could then take into account as they debated and voted on the national budget. This could improve democracy and legitimacy as well as macroeconomic policy-making.

For the information itself to feed into the report, moreover, the EU would do best to set up committees of experts made up of economists, former financial ministers, and the like to advise the Commission, ECB, and/or the member-states where needed, with a right of review by the Council. For oversight various triggers could be put in place, with different levels of investigation of a country’s budgetary policies depending upon the perceived state of its finances and its macroeconomic profile with regard to deficit, debt, and inflation.²¹ But more may be necessary, in particular for member-states in dire straits.

For member-states in trouble, the EU first needs to replace the temporary loan

guarantee mechanism with a fully workable European Monetary Fund. The European Stability Mechanism currently under construction may very well do the trick, depending upon how it is elaborated. Secondly, the EU needs to do the hitherto unthinkable, by exceptionally arranging for “structured” debt restructuring for a member-state in risk of default, with a new European Monetary Fund allowing the country to borrow at reasonable rates from this mechanism rather than from the markets. This is almost certain to be made possible by the proposed ESM. A similar arrangement could be made for non-eurozone members with regard to their peg to the euro. Most economists predict that Greece will need to restructure its debt sooner or later; why not do this in a way so as to restore Greek competitiveness and reduce citizen burden? This would also, however, mean that the European banks most exposed—notably German and French banks—would also have to take “haircuts,” something already mooted by Chancellor Merkel. It additionally speaks to the need for real regulation of the financial markets, to step back from the Greenspan ideology of lending institutions acting in their own self-interest by serving as the invisible hand that would protect shareholder equity. The EU wants a more visible hand of government to bring the markets in line with sustainable growth and healthy competition, as the German ban on short selling signaled. And finally, why not allow the ECB to issue European bonds, or e-bonds, as the head of the eurozone finance ministers, Jean-Claude Juncker, also Prime Minister of Luxembourg, and the Italian Finance Minister, Giulio Tremonti, pleaded in a comment in the *Financial Times* in early December?²² This could vitiate the whole problem of sovereign debt default, by pooling bonds in a much larger entity, beyond any individual eurozone member, although it would be a much greater step toward economic solidarity than even the actions taken so far.

The Political Challenge

The final challenge is political. There needs to be political will to pursue deeper economic solidarity, including the willingness to give up more national sovereignty with regard to economic governance. There needs to be a more European approach to economic governance, including a willingness to consider more flexible economic criteria for evaluation. And there needs to be real political leadership to forge agreements among the member-states as well as to build citizen support.

The main obstacle that has stood in the way of this push toward deeper economic solidarity and more flexible economic governance in Europe has been, surprisingly, Germany, given its reputation as the most pro-European of member-states. However, it is not so surprising when one considers the fact that the Stability and Growth Pact, with its restrictive numerical criteria, is a German creation exported to the rest of

Europe, based on the German model of mid-twentieth century macroeconomic policy success, as is the current austerity policy. This is as if to say that what works for Germany will work for the rest of Europe—although it doesn't. It is also not surprising to note, as Habermas has recently, that Germany has become a "normal" nation once again, as well as completely self-absorbed. With regard to the economic crisis, German leaders have backed themselves and the country into a corner by the way they have been speaking about and dealing with the crisis since the very beginning.


Chancellor Merkel can be singled out. Had she agreed to a bailout back in February, or even March the crisis would not have gotten so bad, Greece's finances might not have been so badly hit by the markets, there would not have been the same risk of contagion to other economies, and so on. Unfortunately, she projected an image of the "Iron Chancellor" demanding that Greece put its own house in order before any help would be forthcoming, claiming that the German Constitutional Court would be skeptical of any Greek bailout, and all the while hoping that Greece would tighten its own belt sufficiently to calm the markets. This was to allow her party to win the Nord Rhine Westphalia elections on 9 May 2010 before any action would need to be taken. Both were major miscalculations. The crisis got much worse and she got a drubbing in the regional election, losing her majority in the upper house.

In the meantime, Merkel's discourse, by following rather than seeking to lead public opinion, made it very difficult for her to legitimate her about-face on the Greek loan, let alone the loan guarantee or any future positive action. Her discourse was all about punishing the Greeks and maintaining the most restrictive adherence to the Stability and Growth Pact. This fueled a nationalistic, media feeding-frenzy that opposed any bailout because it would make "good" member-states liable for the debts of "bad" ones, that emphasized the virtue of good Germans who saved, tightened their belts through budget-cutting and wage-restraint, and that opposed any "transfer union" in which Germans would underwrite the irresponsible South. There was no mention here of the ways in which Germany itself had benefited from consumption in other European countries, with current account surpluses that were partly responsible for the deficits in other countries.

How then to legitimate her reversal of position on the very day of the elections, following negotiations among leaders and a call from Obama? In order to justify this, Merkel came out on national television offering a very thin, economic argument maintaining that, "the future of Europe depended on the bailout" and "it was essential to maintain the stability of the euro." In response to the deep unpopularity of the move, and to critics like the conservative newspaper, the *Frankfurter Allgemeine Zeitung*, which announced that "All of the principles of monetary union have been sacrificed," her government became the defender of the most rigid interpretation

of the Stability and Growth Pact. It did back off from its calls for draconian punishment of offending eurozone members, including loss of voting rights, however, in light of EU Council objections. Merkel's subsequent insistence on the risky strategy of going for a treaty amendment to put into place the ESM was also very much nationally focused. It stemmed from her fears that the Constitutional Court might rule as unconstitutional any permanent mechanism that would not be sufficiently "democratic" because outside the treaties, and arguably in violation of the no bailout clause of the treaties.

Germany's position with regard to austerity for the eurozone will also make it very difficult to move ahead on implementing more growth-oriented economic governance policies for the eurozone. This speaks not only to the problem for Europe when the biggest and richest member-state fails to exercise real leadership, but also to a more general problem for the EU today. All member-states continue to assume that the European economy as a whole is only the sum of its parts, failing to realize that the whole is much more than that, and that for European growth to take off, coordinated European planning is necessary.

What the EU needs, in sum, is forward-looking European leaders seeking to build more growth-oriented EU economic governance while articulating national legitimating discourses that convince their citizens as well as the markets of its benefits. Is this likely? Let us hope so. If not, the prospects for deeper European economic integration among prosperous national economies with generous welfare states may be grim indeed. 

Notes

1. Vivien A. Schmidt, *Democracy in Europe: The EU and National Politics* (Oxford: Oxford University Press, 2006).
2. The risks of stalemate resulting from the unanimity rule prompted me to argue elsewhere for a "treaty to end all treaties" that would eliminate the threat of veto by allowing for agreements to be established by supermajorities (of 2/3 or 4/5 of member-states) with opt-outs. See Vivien A. Schmidt, "Re-Envisioning the European Union: Identity, Democracy, Economy," *Journal of Common Market Studies* 47, Annual Review (2009): 17-42.
3. Ironically, among the PIIGS, only Ireland was assumed at the time not to be a candidate for the EFSF, mainly because it had already begun serious belt-tightening as of 2008 in response to the major banking crises that caused its economy to collapse. This was despite a deficit even higher than that of Greece at 14.3 percent of GDP in 2009.
4. The real numbers were actually higher, having been revised upward to 15.4 percent of GDP once Commission officials were able to vet the Greek government's figures (Eurostat, November 15, 2010).
5. This number was also revised was upward by Eurostat (November 15, 2010) to 126 percent of GDP.
6. Schmidt, "Re-Envisioning the European Union."
7. Susanne Lütz and Matthias Kranke, "The European Rescue of the Washington Consensus?"

- EU and IMF Lending to Central and Eastern European Countries,” paper presented at the 51st ISA Annual Convention, New Orleans, February 17-20, 2010.
8. The EU contributed €45 billion, the bulk of which came from the two EU rescue funds, plus smaller bilateral loans from the UK of €3.8 billion, Sweden of €598 million, and Denmark of €393 million. Of the rest, €22.5 billion from the IMF and €17.5 from the Irish government itself, with €12.5 of this out of the country’s National Pension Reserve Fund (a sovereign wealth fund) and cash reserves.
 9. On the arguments for why such a sovereign debt crisis resolution mechanism was necessary, whether with or without a treaty amendment, see: François Gianviti, Anne O. Krueger, Jean Pisani-Ferry, André Sapir, and Jürgen Von Hage, “A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal,” *Bruegel Blueprint Series*, November 9, 2010.
 10. “Huge National Debts Could Push Euro Zone into Bankruptcy,” *Der Spiegel Online*, May 3, 2010, <http://www.spiegel.de/international/europe/0,1518,692666,00.html>
 11. The pro-growth supporters also include former government ministers. See, for example, the comment of Alasdair Darling, former Chancellor of the Exchequer, in the Labor government, in the *Financial Times*, December 5, 2010.
 12. K National Statistics Office, March 31, 2010.
 13. See Paul de Grauwe, “Fighting the Wrong Enemy,” *Vox*, May 19, 2010, <http://www.voxeu.org/index.php?q=node/5062>
 14. Wolfgang Münchau, “The Eurozone’s Tragic Small-Country Mindset,” *Financial Times*, June 13, 2010.
 15. *Ibid.*
 16. Peter Hall and David Soskice, *Varieties of Capitalism*, (Oxford: Oxford University Press, 2001).
 17. Vivien A. Schmidt, *Futures of European Capitalism*, (Oxford: Oxford University Press, 2002); Vivien A. Schmidt, “Putting the Political Back into Political Economy by Bringing the State Back Yet Again,” *World Politics* 61, no. 3 (2009): 516-548
 18. See Fritz W. Scharpf and Vivien A. Schmidt, *Welfare and Work in the Open Economy*, (Oxford: Oxford University Press, 2000).
 19. See Andreas Nölke, and Arjan Vliegthart, “Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe,” *World Politics* 69, no. 4 (2009): 670-702.
 20. Alfio Cerami and Pieter Vanhuysse, eds., *Post-Communist Welfare Pathways: Theorizing Social Policy Transformations in Central and Eastern Europe* (Basingstoke : Palgrave Macmillan, 2009).
 21. Michael Burda and Stefan Gerlach, “Greek Lessons,” *Vox*, May 11, 2010, <http://www.voxeu.org/index.php?q=node/5029>
 22. Jean-Paul Juncker and Giulio Tremonti, “E-Bonds would end the Crisis,” *Financial Times*, December 5, 2010.