The Euro crisis: Towards a Fiscal and Political Union?

A Conference at the European Commission London office, Europe House, organised by the LSE Centre for International Studies

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Why the Eurozone crisis needs to get worse before it is solved

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"It seems that we need more trouble in the Eurozone periphery before we see bold political steps toward solving the crisis." This statement by Waltraud Schelkle, from LSE, is a good summary of the content of the two-day event on the Eurozone crisis that Professor John Ryan and I organised, under the auspices of the Centre for International Studies, at LSE (the first day in an academic seminar) and the headquarters of the European Commission in London, the House of Europe (the second day with a full day conference), on 29 and 30 November 2012.

During these two days we had the privilege to discuss the role of Germany in the Eurozone crisis and the possibility of a fiscal and political union in Europe with some of the most respected experts on these topics. Apart from Waltraud Schelkle from the European Institute at LSE, we had Jacob Kirkegaard, from the Peterson Institute, Clemens Fuest, from the University of Oxford, Luis Garicano, from LSE, Heribert Dieter, from the German Institute for International and Security Affairs, and Gabriel Glöcker, from the ECB. To facilitate discussion and analysis, we were joined by Bob Hancké, from LSE, and Magnus Ryner, from King´s College London, who acted as discussants, and we enjoyed active participation from representatives from the House of Lords, the European Parliament, the IMF, national diplomatic services and specialised media.

Generally, the consensus among the participants is that we are dealing with a complex, multidimensional crisis that can be divided in competitiveness, a fiscal, banking and a political crisis. Clemens Fuest, for example, focused his attention on the competitiveness problems of the Eurozone periphery in an increasingly globalised world. He acknowledges that there has been certain rebalancing between the Eurozone periphery and the core since the beginning of the crisis, but for him, with the exemption of Ireland, the improvements in Greece, Portugal, Spain and Italy have been minor. The reductions in unit labour costs and current account deficits in these countries appear to stem from high unemployment and lower wages and massive cuts in imports rather than from an improvement in productivity. Furthermore, Fuest warns that if the current pattern of negative growth and relatively high interests in the sovereign debt markets persists, in addition to Greece several of these countries might become insolvent too.

Luis Garicano, on the other hand, offered a comprehensive analysis of the Spanish banking crisis. In his opinion, and this is shared by the other participants, a Eurozone banking union is absolutely necessary to break the diabolic feedback loop between sovereigns and banks. In this regard, he criticised the recent decision by the ministers of finance of the creditor countries to exclude legacy debt from the prospective banking union arrangements. In Garicano's opinion if the Spanish state has to fully guarantee the debt of the Spanish banking system it is unlikely to see Spain becoming attractive for foreign investors because they will fear huge tax burdens in the future. As my co-organiser John Ryan has pointed out during our discussion: "where there are irresponsible debtors, there are irresponsible lenders." Therefore, it seems only logical that some of this legacy debt will have to be mutualised to share some of the huge adjustment costs that are taking place.

(left to right) Luis Garicano, LSE speaking about the Eurozone crisis, John Ryan, LSE Chairman of conference listens

So far, however, the adjustment is happening in the Eurozone periphery and Jacob Kirkegaard explains why. In his opinion Germany has been quite successful in using the effects of the crisis for its own advantage. Using the 'game of chicken' metaphor he makes a compelling case on how Germany has early on in the crisis realised that the impact of the crisis would be asymmetric and thus that in this brinkmanship battle to solve the crisis between more solidarity and more centralised control of national budgets the periphery will blink first. For Kirkegaard this is above all a political crisis. The fundamental problem is that the Eurozone countries are not willing to hand in their sovereignty to the centre. Until this is the case, the crisis will persist, and Germany will not move.

Of course, the history of monetary unions, the state theory of money and the optimum currency area (OCA) theory support Kirkegaard´s argument. A currency area can only survive if it has a centralised political authority to underpin it. Even Benoit Coeure, who is currently one of the permanent executives at the ECB, has recently accepted this logic. His words are significant because this is the first time that a high profile policymaker at the ECB moves away from the orthodox understanding of money as a neutral medium of exchange and engages with the state theory of money.

So is the only solution to the crisis a United States of Europe? Heribert Dieter argues that this would be a huge mistake, which is a thought that is increasingly shared among European scholars. The European societies are too diverse and divergent to be managed by a centralised power. In Dieter's opinion the European publics would be against this move, especially the German population. This is the reason why Angela Merkel has never attempted to sell her vision of Europe to her electorate. Her political union idea is just too unpopular, at least for the moment (although, perhaps it is so unpopular precisely because she has never dared to explain it). She might be able to push through a federalised or decentralised (German dominated) banking union because this is a technical area, and it seems that this move is economically indispensable for the survival of the euro, but political union is a non-starter with the German public. This is at least Dieter's view.

The question though is can the Eurozone have a banking union with a resolution fund and a deposit insurance scheme without a political union? Having a single banking supervisor has major implications. Who will determine how the ECB´s supervision needs to be executed, under which guidelines and with what kind of democratic legitimacy? Banking union, with all its economic and political implications, is for many a fiscal union through the back door. No wonder Germany is starting to have cold feet on this particular topic. As Waltraud Schelkle points out since Mario Draghi came out in July 2012 with his ground breaking speech on the irreversibility of the euro and his determination to do whatever is required to save the single currency, which then led to the Outright Monetary Transactions (OMT) programme, creditor countries have slowed down progress on the banking union and debtor countries have shied away from asking for a rescue programme. It seems that we need more trouble in Spain or Italy to move toward further economic and political integration. Perhaps the economic situation in Germany needs to worsen for the German government to launch a new stimulus package like in 2009.

This shows that the Eurozone is really becoming the world champion in piecemeal solutions and muddling-through. Gabriel Glöcker, from the ECB, laments this circumstance. He says that the markets demanded a comprehensive reform package in Eurozone governance and actually this is what has been delivered but, because it has been agreed incrementally after long negotiations and consensus-building, it has been much less successful in generating a positive market dynamic.

Nevertheless, one should not underestimate the progress that has been achieved. Some of it would be unimaginable only three years ago. The Eurozone has now a permanent rescue mechanism, the ESM (a de facto European Monetary Fund) which has the capacity to intervene in the secondary and primary sovereign debt markets and can also inject funds to the national banking systems; Eurozone member states have signed the six-pack, the two-pack and the fiscal compact which will be enshrined in constitutional law or similar; they have also agreed to hold regular Eurogroup meetings at heads of states and government level. In exchange, the ECB has expanded dramatically its non-conventional tool box with the Securities Market Programme (SMP), the Long Term Refinancing Operation (LTRO) scheme and the mentioned Outright Monetary Transaction (OMT) programme, which aims to strike the right balance between solidarity, conditionality and the avoidance of moral hazard. On top of this, the four presidents (European Council, European Commission, Eurogroup and ECB) are working on a 'genuine economic and monetary union' framework and the member states are currently negotiating the creation and implementation of a banking union.

This is a lot of institutional change in a relatively small amount of time for European standards. Unfortunately, it is still not enough to solve the crisis. There are still many open questions on how to deal with legacy debt; on what kind of banking union will be created; on how to reignite growth; and whether it will be necessary to have a centralised Eurozone budget and mutualisation of prospective debt, and consequently whether we will have one day the equivalent of a Eurozone minister of finance who will have the democratic legitimacy to shape and control national budgets.

There is no doubt that there are huge political obstacles for these moves to happen, hence perhaps the sad truth that comes out of our discussions is that things might have to get worse before the European leaders take the bold steps that are necessary for the euro to survive. In this regard, Kirkegaard quotes Wolfgang Schäuble, the German Finance minister: "When things get really difficult…suddenly solutions which seemed impossible become possible…Sometimes you need a little pressure for certain decisions to be taken". It seems that we will have to wait for this little pressure.

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Programme

09.45 Welcome
European Commission
Conference Chair John Ryan LSE

10.00 Outlook on the National Debt Crises

Luis Garicano, LSE

10.50 Coffee break

11.05 Closer Fiscal Policy among Eurozone Members

Jakob Funk Kirkegaard, Peter G. Peterson Institute for International Economics

11.55 Structural Reforms of National Budgets of EU Member States

Clemens Fuest, Oxford University

12.45 Lunch

13.30 The European Rescue Packages – will they save the Euro?

Heribert Dieter, German Institute for International and Security Affairs, Berlin

14.20 The eurozone crisis: The view from the ECB?

Gabriel Glöckler, European Central Bank

15.10 General discussion

15.40 Concluding comments: Miguel Otero-Iglesias LSE

16.00 Close

Short Biographies of Contributors:

Luis Garicano is Professor of Economics and Strategy at the Department of Management and at the Department of Economics at LSE. In 2011, he and several European economists put forward a proposal for ESBies, a form of Eurobond to back up Europe's financial architecture. He advised the previous Spanish government on its crisis management.

Clemens Fuest is Research Director of the Oxford University Centre for Business Taxation and Professor of Business Taxation. He is a research fellow of CESifo and IZA and advisory editor of the Canadian Journal of Economics. He is a member of the Academic Advisory Board of the German Federal Ministry of Finance and member of the Academic Advisory Board of Ernst and Young AG, Germany. He has a PhD in economics from the University of Cologne. Prior to Oxford, he was a lecturer at the University of Munich and a professor of economics at the University of Cologne.

Heribert Dieter has a PhD in Economic and Social Sciences at the Free University of Science in Berlin. Senior Research Associate in the Research Unit Global Issues at the German Institute for International and Security Affairs, in Berlin (tenure) and Associate Fellow in the Centre for the Study of Globalisation and Regionalisation at the University of Warwick (UK) since August 2000.

Jacob Funk Kirkegaard has been a research fellow at the Peter G. Peterson Institute for International Economics since 2002 and is also a senior associate at the Rhodium Group, a New York-based research firm. Before joining the Institute, he worked with the Danish Ministry of Defense, the United Nations in Iraq, and in the private financial sector. He is a graduate of the Danish Army's Special School of Intelligence and Linguistics with the rank of first lieutenant; the University of Aarhus in Aarhus, Denmark; and Columbia University in New York.

Gabriel Glöckler has been with the European Central Bank since 1999, and is currently Deputy Head of the EU Institutions Division within the Bank's Directorate General International and European Relations. As such, he is in charge of the ECB's interaction with "Brussels" and actively involved in the ongoing European discussions on the sovereign debt crisis, the further evolution of economic governance and the crisis resolution efforts. Previously, he served five years as Counsellor/Chief of Staff to the ECB's Vice-President Lucas Papademos and before that as (Senior) Economist. Prior to joining the Bank, he was teaching at the College of Europe. Gabriel, who grew up in Leipzig (East Germany), studied Philosophy, Politics and Economics at St. Edmund Hall, Oxford University and holds a Master's degree from the College of Europe in Bruges. His areas of expertise cover European monetary, economic and political integration; economic governance and reform of the governance framework; crisis management and the European financial stability and supervision framework.

Short Biographies of Organisers:

John Ryan is a fellow at the Centre for International Studies, LSE and works as a senior adviser for private and public sector organisations. John Ryan was a fellow at the EU Integration section of the German Institute for International and Security Affairs, Berlin, Germany, Centre for Economic Policy Analysis, University of Venice, Centre for European Studies Sciences Po Paris, CRG Ecole Polytechnique Paris, and Center for European Integration Studies, Bonn. John Ryan has held senior administrative and academic positions at various business schools. John Ryan was educated at Oxford and Cambridge Universities, London School of Economics and Political Science and Kiel Institute of World Economics, Germany. His current areas of research are: Eurozone Crisis, Global Currencies and Credit Rating Agencies.

Miguel Otero-Iglesias is Assistant Professor in International Political Economy at ESSCA School of Management in Paris and Visiting Research Fellow at the London School of Economics. He is a regular visiting research fellow at the Institute of World Economics and Politics within the Chinese Academy of Social Sciences. His areas of expertise are: European and global monetary governance, the political economy of EU relations with China and Brazil, and theories of money and power. Previously he has been an Adjunct Lecturer at the University of Oxford and Associate Lecturer at Oxford Brookes University. He is a regular contributor to European think tanks, including the Royal Elcano Institute, where he is an external research fellow.