

# The Euro Crisis: Will it Lead to Better and Stronger Governance?

## Cinzia Alcidi

LUISS Research Fellow  
The Centre for European Policy Studies, Brussels

## Daniel Gros

Director  
The Centre for European Policy Studies, Brussels

For some years now Europe has been producing only dire news, and since early 2010 the euro crisis has gone from bad to worse. Despite significant efforts aimed at improving European governance, the creation of a rescue fund for the euro area, and a sovereign default (Greece), in mid-2012, uncertainty remains extremely high and financial turbulence still dominates market conditions.

Oddly enough, this picture combines with fundamentals in the euro area as a whole that look sound, especially if compared to the US. The average sovereign debt relative to GDP in the euro area is less than 90%, while it is more than 100% in the US. The budget deficit is also smaller in the euro area: in the US, it reached almost 10% of GDP in 2011, while it was about 4% in the euro area. Moreover, unlike the US, which has run a large current account deficit for decades, the euro area has, since its creation, always had a balanced current account or small surpluses. The latest indicators suggest that, unlike in the US, there are enough savings within the European Monetary Union to finance the public deficits of all euro-area Member States. This in turn means that, unlike in the US, there are enough domestic resources within the euro area to solve its debt problem without the need to rely on the external financing so often advocated in calls for IMF and foreign investors' support. In spite of the relative strength of these fundamentals and a long series of meetings of heads of state and finance ministers, Europe's policymakers have failed

to solve the euro debt crisis and to convince markets of the value of their approach and commitments. Against this background, two key questions remain unanswered. First, how can this be explained? Second, will the crisis offer other opportunities to improve the governance of the European Union and the European Monetary Union?

## The Long Road to Improving Governance in the Euro Area

The original design of the Economic and Monetary Union (EMU), as established by the Maastricht Treaty in 1992, contained three key elements regarding the Union's governance. The first was an independent central bank (the European Central Bank) committed to achieving and maintaining price stability. The second was the Stability and Growth Pact (SGP), essentially an intergovernmental agreement within the framework of the EU's legal system that was supposed to limit fiscal deficits through an "excessive deficit procedure." The last, only recently fully recognised, was the "no bailout," or rather "no co-responsibility," clause (Art. 125 of the Treaty on the Functioning of the European Union). The treaty also touched on other aspects of economic governance (e.g. making reference to the concept of economic policy as a common concern), but they remained mostly on paper as in reality Member States did not see any need to coordinate their economic policies.

The idea of an independent ECB always enjoyed a broad consensus amongst both economists and policymakers based on a common understanding that decades of high inflation had not brought more growth and, ultimately, a central bank can only achieve price stability. In contrast, the second element of the treaty, namely, the Stability and Growth

Pact (SGP), did not enjoy the same consensus amongst academics or policymakers. In the 1990s, an extensive debate took place regarding the logic of the Maastricht threshold values of 3% of GDP for the budget deficit and 60% for debt, and in 2003 even the core countries conspired to weaken the limits set by the SGP.

The third element was only in the background and remained untested until recently. Contrary to a widespread misconception, the so-called “no bailout” clause included in Article 125 of the treaty does not prohibit bailouts. It merely states that the EU cannot take on the liabilities of its Member States and that Member States do not guarantee each other’s obligations. At the time of the negotiations of the Maastricht Treaty, Germany had strongly insisted on the inclusion of the clause to ensure protection against fiscal profligacy, but, after being forced to agree to a large bailout, it recently discovered that the clause was not able to provide the protection it had sought. Faced with this reality, German policymakers have been trying to achieve a single objective: to ensure lower fiscal deficits across the Union. This is indeed the ultimate purpose of the Fiscal Compact Treaty, under which euro-area Member States agree to adopt stricter rules to limit fiscal deficits. Will the Fiscal Compact work where the Stability Pact failed? Will it be enough to solve the euro-area crisis? The most likely answer to both questions is “no” for two reasons. First, the approach assumes that the euro crisis is simply a fiscal crisis. As this is not true, it will not solve the crisis. Second, as will be argued in more detail in the following two sections, the problem of fiscal indiscipline was not due to a lack of rules, which already existed, but rather to the failure to enforce the SGP. Not much has changed on this front under the Fiscal Compact.

### *The Experience with the Original Fiscal Rules*

The “original” SGP already contained a commitment to balanced budgets over the cycle. Had it been implemented, it would have led to a continuous reduction of the debt-to-GDP ratio. Alas, it was not. The provision in the SGP to balance budgets over the cycle was non-binding and widely ignored. On average, fiscal deficits were close to the 3% threshold over the cycle, but all large euro-area Member

States, including Germany, ran budget deficits in excess of this target in the first years of the euro’s existence. In 2003, the Commission’s proposal to apply the excessive deficit procedure, including fines, to France and Germany was defeated in the Council. In the crucial vote, the large countries (France, Germany and Italy) colluded to reach a qualified majority to “hold the procedure in abeyance.”<sup>1</sup> This experience is very telling in light of the fact that the new Fiscal Compact is supposed to radically strengthen the enforcement of the fiscal rules by applying the “reverse qualified majority” principle, whereby a proposal of the Commission within the excessive deficit procedure is considered approved unless it is opposed by a qualified majority.

In 2005, the SGP was officially amended to improve its economic rationale and thus ownership.<sup>2</sup> The reaction in academia was mixed: according to some, the SGP was “softened”; according to others, it was “improved.” In hindsight, this very lack of consensus amongst the experts on the merits of “binding rules for fiscal policy” helped to make the change in the SGP widely acceptable, if not necessary. This is likely to happen again.

In fact, shortly after the SGP was made less stringent, the upturn in the business cycle allowed most governments to reduce their deficits to below the 3% threshold, seemingly vindicating the official position according to which the “improved” Stability Pact had led to more responsible fiscal policy. In reality, deficits adjusted for the cycle improved very little even towards the peak of the boom in 2006-07, and when the crisis hit, deficits were allowed to increase again. Overall, individual euro-area countries never fully met the rules they made for themselves, yet on average the euro area remained relatively conservative in fiscal terms compared to the US and the UK. In this limited sense, the Maastricht provisions against excessive deficits did have some influence. But, as often happens, averages can hide significant differences. While the average deficit for the euro area as a whole appeared modest by the standards of other large, advanced countries, one euro-area Member State, Greece, clearly violated all the rules for years. It is thus understandable that some policymakers, Germany in particular, believe tighter fiscal rules are essential for the survival of the euro. However, two things should be kept in mind.

<sup>1</sup> See Gros et al (2004).

<sup>2</sup> <http://register.consilium.europa.eu/pdf/en/05/st07/st07619-re01.en05.pdf>

First, the track record of the SGP proves that writing rules alone is not enough. The rules must be enforced. In this regard, the experience of the SGP suggests that how new rules will be applied in future will depend on the degree of consensus on the need for them. Second, it should be recognised that the mounting evidence that the Greek fiscal numbers did not add up was never acted upon while it was politically inconvenient to do so. Only when financial markets stopped providing financing at favourable rates was the Greek profligacy recognised, but by then it was too late to avert the catastrophe.

### *The Prospects for the New Fiscal Rules*

The treaty embedding the so-called Fiscal Compact has a long title – *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* – but deeper inspection suggests it is rather short on new content.

This new treaty is reminiscent of the Stability and Growth Pact in several ways. Like the SGP, the main purpose of the Fiscal Compact is to avoid fiscal profligacy; the difference, at least on paper, is that the system of enforcement remains at the national level, where fiscal sovereignty lies. In addition, as before, once the commitment to fiscal discipline was broadly achieved and the new treaty signed, the policy debate started to shift to growth and, just as how, in 1990, the Stability Pact was changed to the Stability and Growth Pact, many are now advocating a growth pact. While this makes a lot of sense, there is a great temptation to see it simply as history repeating itself.

The only really substantive binding provision of the Fiscal Compact is that each of the 25 signatory Member States undertakes to introduce permanently in its national legal system, preferably at the constitutional level, within one year of the treaty coming into force, rules that limit their annual structural deficit to 0.5% of GDP.<sup>3</sup> If a Member State fails to take these steps, the European Commission is required to take it before the European Court of Justice (ECJ). In case of non-compliance with the ECJ verdict, the Court could fine the Member State with a penalty capped at 0.1% of GDP. Hence, the pact concerns only the broad rules that Member States have to follow in setting up their balanced-budget laws, not the

implementation of these national rules. The treaty thus does not grant new powers to interfere in the conduct of national fiscal policy to the Court of Justice or the Commission.

## **The main value of the Fiscal Compact is that the political statement it contains provides political cover for the German government in its efforts to sell the euro rescue operations to a sceptical domestic audience**

The treaty also contains some sweeping non-binding provisions on economic policy coordination, reaffirming good intentions on structural reforms and instituting regular meetings of the heads of state of the euro area (at least twice a year), although they will remain informal.

Quite a lot of debate has arisen over the fact that several non-euro EU Member States have signed the Fiscal Compact. In fact, this does not entail any obligations for them. Their signature is simply a political statement, allowing them to participate in most of the euro-area summits without any real influence on the decision-making process.

Beyond specific provisions, the main value of the Fiscal Compact is that the political statement it contains provides political cover for the German government in its efforts to sell the euro rescue operations to a sceptical domestic audience. However, it is uncertain that the Fiscal Compact was really needed for this purpose. German public opinion has remained much more constructive on the euro than widely assumed (Gros and Roth, 2011), and even before the Fiscal Compact all votes in the Bundestag resulted in very large majorities in favour of all euro-area rescue operations, even when they contained significant fiscal risks for Germany.

Overall, in judging the value of this treaty, two factors should be kept in mind. First, of the four large euro-area countries, three have already introduced national debt brakes at the constitutional level: Germany, where they are already operational, and Spain and Italy, which have adopted them. The uncertainty

<sup>3</sup> Member States with a total debt exceeding 60% of their GDP must run a structural deficit of no greater than 0.5% of GDP, while Member States with a lower debt-to-GDP ratio can run up slightly less restrictive deficits of up to 1% of GDP.

is mostly regarding France, where it has been agreed that the French constitution will not be changed even if the treaty is implemented. This suggests that the treaty's added value is limited.

Second, the prominence of the notion of structural deficit in the Fiscal Compact may be a source of uncertainty. This variable is often referred to by economists as a "known unknown": it can be estimated but not observed directly. Indeed, the structural deficit is computed by adjusting the actual deficit (as determined by Eurostat) by a factor encompassing a measure of the impact of the business cycle on the budget deficit. Alas, it is very difficult to measure this factor, let alone do so in a timely fashion. The Commission and Eurostat change their estimates of the structural deficit considerably over time. The question becomes: what if, due to a revision of the estimates, a country were to become non-compliant with the constitutional rule? What should be done then? All in all, the Fiscal Compact may be of some use in that it ultimately forces all 25 Member States to adopt stronger national fiscal frameworks at home. However, it will probably still make only a marginal difference as some, perhaps even most, countries would have done so anyway, adopting such a framework under pressure from the markets.

There are two main risks associated with the Fiscal Compact. The first is that it has been oversold. It constitutes neither a first step towards fiscal union nor significantly better European economic governance, but it is nevertheless likely that the ratification process (e.g. the referendum in Ireland) and the subsequent process of its implementation in some countries (e.g. France) will receive a lot of attention and create a distorted impression of its importance. The second is that it could exacerbate divisions within the Union. Given the very difficult economic situation in some countries, the implementation of further austerity measures in order to comply with the EU rules is very costly (several governments

have fallen across Europe on austerity measures), but debtor countries have been required to commit to austerity in exchange for vital financial support from creditor countries. As austerity alone not only seems incapable of overcoming the crisis, but also likely to deepen the recession, opposition to it and hostility towards creditor countries risk increasing and worsening divisions.

## Competing Policies and Institutions

The euro debt crisis has been exposing weaknesses in the EU framework across a number of fronts, most prominently in the distribution of resources. Differences among Member States are bound to arise even more when one group depends on the other for financial support. The endless discussions about the EU's budget provide repeated reminders of the fact that redistribution across Member States remains the most divisive issue for the EU. The crisis has significantly increased the amount of the resources in question, which suggests that divisions could increase as well.

In the "Community" method, the Commission plays a central role: it has the monopoly (or sole right) of initiative. However, this traditional prerogative has been irrelevant for the euro crisis, as the Commission does not have control over financial resources. The Commission has been *de facto* sidelined by the euro-area summits of heads of state ably presided by the President of the European Council, Herman van Rompuy. This new formation of the European Council appears to have become important, but it is debatable to what extent it has actually shaped events, as major decisions have usually been taken only when the financial markets have been close to collapse.

Moreover, the crisis has skewed the power balance among Member States to such an extent that the traditional notions of decision-making (i.e. simple

TABLE 1 Changes in Net Trust in National and European Institutions in Comparison to the EMU

Trust in (sample):	Spring 2008	Spring 2011	Difference Spring 2008– Spring 2011
EU (EU-27)	14	-6	-20
Membership in the EU (EU-27)	38	15	-23
EC (EU-27)	19	2	-16
EP (EU-27)	23	6	-17
ECB (EA-12)	29	2	-27
Net support for the EMU and the euro (EA-12)	40	38	-2

Notes: Information in parentheses indicates the population surveyed. EC= European Commission; EP= European Parliament; ECB= European Central Bank; EA = euro area.  
Sources: Roth et al. (2011).

majority, qualified majority and unanimity) have become meaningless as nothing important can be decided without the consent of the key creditor country, Germany. In essence, the countries in need of financial assistance have to submit to a dictatorship of their creditors that is formally intermediated by the European Council and the Commission.

The treatment of debtor and creditor countries has become asymmetric with regard to the mechanisms for mutual surveillance. While the performance of the debtor countries is carefully screened, creditor countries seem free to do whatever they deem appropriate since their economies are relatively strong. In this regard, it will be interesting to see how the situation will evolve in the Netherlands. The expectation is that some sort of compromise will be reached. Extra measures towards consolidation will be required but nothing too strong so as not to impair a fundamentally sound economy.

## Unlike in the US, there are enough domestic resources within the euro area to solve its debt problem without the need to rely on the external financing so often advocated in calls for IMF and foreign investors' support

Table 1 shows how public opinion has become disenchanted with European integration in general. The regular Eurobarometer surveys show that trust in the EU institutions (Commission, Parliament) has strongly declined, although in most cases it remains higher than the trust citizens accord their own national institutions. Support for European integration in general has also strongly declined, and the only bright spot is that, surprisingly, support for the euro has declined very little and remains higher than it was at the start of the EMU.

Unfortunately, trust in the EU institutions has fallen most in those countries that have received the most help and have had to undertake the most draconian adjustment measures.

A tighter fiscal union might be one outcome of the

euro crisis, but even if it were to materialise it would be the result of necessity, rather than of enthusiasm for deeper integration. A fiscal union that was pushed by the debtor countries to get easier access to financing, and grudgingly accepted by the creditor countries to limit the cost of rescue operations, is unlikely to work well and even less likely to offer an attractive example of the benefits of deeper integration.

## Conclusions

The official reading is that the euro crisis is not a crisis of the euro but of the public debt of certain profligate euro-area Member States. Dealing with this crisis, and preventing future ones, thus only requires a new, tighter framework for fiscal policy – which will be delivered by the Fiscal Compact. However, financial markets are definitely not impressed by the magnitude of this change. Italy, Spain and other countries still have to pay very high risk premiums, while Greece teeters on the brink of a total collapse. It is thus clear that this approach captures only part of the problem, and European governance focusing only on fiscal discipline is likely to get nowhere.

Unfortunately, at this stage damage control seems to remain the only achievable goal. The broad picture that is slowly emerging is that the fiscal authorities (within the European Financial Stability Facility) should handle the adjustment programmes, while the ECB should become a lender of last resort for sovereigns under speculative attack.

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