

THE EURO CRISIS AND THE FUTURE OF EUROPEAN INTEGRATION

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From a long-term historical perspective, the European Union is one of the most distinctive political creations of the late twentieth century—a vehicle for supranational cooperation just short of a political federation but more robust than an international regime. After half a century marked by economic depression and two world wars, the economic community established by the 1957 Treaty of Rome became the vehicle for one of the longest periods of peace and prosperity the European continent has ever enjoyed.

However, the European Union is in trouble today, seemingly unable to deliver the peace and prosperity that has always been its promise. The long-running Euro crisis is the most prominent manifestation of its problems. A slow-moving debacle, the crisis has laid bare the fault lines of the European Union. But the problems with which the EU must cope extend well beyond it. Annual economic growth among the 28 member states now in the EU was lagging well before the crisis, at 2.6 percent versus the 3.3 percent growth rate in the U.S. between 1997 and 2006.

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Moreover, low birth rates will make it difficult for Europe to achieve high rates of economic growth in the coming years. The old-age dependency ratio in the EU is expected to double by 2080, leaving only two people of working age for each one over the age of 65. Immigration offers a solution to that problem, but it is meeting fierce resistance in the polities of Europe, where radical right parties opposed to immigration and the policies of the European Union are on the rise. The EU itself lacks an effective policy for coping with boatloads of refugees crossing the Mediterranean in unprecedented numbers.

Meanwhile, the European Union's record as a guarantor of peace and democracy in Europe is being tarnished by its inability to prevent a resurgent Russia, under Vladimir Putin, from absorbing pieces of Ukraine or to deter Hungary, one of its own member states, from sliding back towards semi-authoritarian rule. Of course, Europe has always faced challenges, but to many people, the European Union now seems to be part of the problem rather than the solution. In order to understand why, we need to look back at the evolution of European integration.

The Evolution of the European Union

From its inception in the European Coal and Steel Community of 1951, institutional integration in Europe has always been multiply motivated. On the one hand, for some, it has been animated by the ideals of an "ever closer union" culminating in the European polity envisioned by its founders, Jean Monnet, Robert Schuman, and Alcide De Gaspari. On the other hand, integration has moved forward only when national governments could see how European institutions would serve their own country's interests.¹

EACH NEW STEP TOWARD INTEGRATION HAS BEEN BASED ON LONG TERM GAINS, EVEN IF THEY REQUIRED SHORT-TERM SACRIFICES

Conceptions of national interest are circumscribed by economic and geopolitical conditions, but they are ultimately a social construction. As such, they are affected by the discount rate that governments attach to future gains, by officials' confidence in how a new set of institutions will function, and by a government's sense of the opportunity costs of moving in one direction rather than another.² In this respect, visions of what Europe could be influence the pragmatic decisions taken to get there. Charles de Gaulle was not the only leader motivated by *une certaine idée de l'Europe*.

1 A. Moravcsik, *The Choice for Europe* (Ithaca: Cornell University Press, 1998).

2 J. Goldstein and R. Keohane, eds., *Ideas and Foreign Policy* (Ithaca: Cornell University Press, 1993).

Therefore, European integration has often been served by a certain “constructive ambiguity” about what its next steps would mean for each of the member states. For the most part, however, each new step toward integration has been based on the perception that it would offer the member states positive-sum returns, namely, long-term gains for all, even if they required short-term sacrifices by some. This point is important for understanding the dilemmas Europe faces today.

During the 1950s and 1960s, European integration offered gains that were relatively clear. The European Economic Community provided a vehicle for economic reconstruction and peace in Western Europe. A generation decimated by war took those as superordinate goals. The Single European Act of 1986, which was to create a single continental market by 1992 on the basis of qualified-majority voting, was presented as a means to secure prosperity after a decade of Eurosclerosis.³ The member states knew that liberalization would require some sacrifices but were persuaded that the long-run outcome would be greater prosperity for all.

In large measure, these ends dictated the means used to secure them. Since its core objective was greater economic efficiency, the European Community of the 1960s and 1970s was designed and presented largely as a technocratic enterprise. Of course, national governments retained the final say, and the Community acquired a patina of popular participation when the European Parliament became an elected body. But the actions of the European Community were legitimated largely by reference to their technical efficiency. The committees of the Council were enjoined to base their decisions on technical expertise, and the Commission justified its proposals on the basis of economic efficiency.⁴

As the ambit of European decision-making expanded, however, cracks began to appear in this facade. When the EC focused on narrow realms of regulation with few distributive consequences, its policies could be justified on the grounds of technical efficiency. But, after the Single European Act, the liberalizing regulations of the EU began to affect large segments of the workforce, generating losers as well as winners. European officials had complained for decades that their efforts went

3 N. Jabko, *Playing the Market* (Ithaca: Cornell University Press, 2006).

4 C. Joerges and J. Neyer, ‘From Intergovernmental Bargaining to Deliberative Political Processes: The Constitutionalisation of Comitology,’ *European Law Journal* 3 (1997:), 273-99.

unnoticed. Suddenly, they acquired much higher political visibility, and people who felt disadvantaged by liberalization or globalization began to blame their fate on the EU. The result is a legitimacy crisis from which the European Union has yet to emerge fully.

Of course, democratic governments often allocate gains and losses among social groups, and they legitimate those decisions on the grounds that the last elections gave them a mandate to do so and the next elections will hold them accountable for their actions. This is the basis for the “political capacity” of democratic governments in contexts where “to govern is to choose.” But the European Union lacks such political capacity. Its Commission is unelected, and its Council strikes deals under a veil of secrecy for which none of its members can readily be held accountable.⁵

In the treaties of Maastricht and Lisbon, the response of the European Union to this legitimacy crisis was to increase the powers of its Parliament while extending the jurisdiction of the EU even further. But complex decision-rules obscure the role of the Parliament, and elections to it are generally decided on national rather than European issues, in the absence of a cohesive continental electorate or Europe-wide parties. In the eyes of many of its citizens, the EU continues to look like a technocracy. Europe suffers from the kind of sharp divide between the *pays légal* and the *pays réel* once said to have characterized France during the Third Republic. As a result, the legitimacy of the EU turns heavily on its capacity to promote prosperity across the continent.⁶ That is why the Euro crisis raises deep political as well as economic dilemmas for Europe.

The Origins of the Euro Crisis

Like all such initiatives, the decision to establish the Economic and Monetary Union in Europe was multiply motivated: EMU was both an economic and political construction. Officials, such as Jacques Delors, the president of the European Commission, saw EMU as a way to deepen the single market. President François Mitterrand of France hoped monetary union would reduce the influence that the German

5 S. Cox, *What's Wrong with the European Union & How to Fix It* (Cambridge: Polity, 2008).

6 F. W. Scharpf, *Governing in Europe* (Oxford: Oxford University Press, 1999).

Bundesbank held in the prior European monetary system. Chancellor Helmut Kohl of Germany saw it as a way to bind a newly-unified Germany to Europe, ensuring its trading partners could not gain advantages over German products by devaluing their currencies. Each leader had reasons for pursuing monetary union, even though economists warned that Europe was not an “optimal currency area.” It lacked the capacities to adjust to economic shocks conferred by high rates of labor mobility and social insurance schemes capable of automatically redistributing revenues to regions suffering from recession.⁷

THE ECB WAS CHARGED WITH MAINTAINING FINANCIAL STABILITY BUT FORBIDDEN FROM PURCHASING SOVEREIGN DEBT

The institutions constructed for the new monetary union were minimal at best. The new European Central Bank was charged with maintaining financial stability but forbidden from purchasing sovereign debt. Therefore, it lacked the tools most central banks wield for fending off speculative attacks in the bond markets. The premise was that monetary union should never entail transfers between the member states, thereby establishing monetary solidarity without any corresponding foundation of social solidarity, a flaw that was to haunt it in future years.

Despite these limitations, the single currency worked well enough for the European Commission to declare, ten years after its establishment, that “The single currency has become a symbol of Europe, considered by euro-area citizens to be among the most positive results of European integration.” Within months, however, the Euro crisis had erupted. So what went wrong? Why did Europe face a sovereign debt crisis from which it has yet to fully emerge?

The basic answer is that Europe suffered from the same kind of profligate lending and borrowing, fueled by new types of financial derivatives and light-touch regulation, which precipitated a financial crisis in the U.S. and global recession in 2008. The most egregious case is that of Greece, whose revelation, in October 2009, that its budget deficit would be almost three times the projected level (later found to be 15.6 percent of GDP), touched off the crisis of confidence in sovereign debt. As skittish

⁷ For a review, see: F. P. Mongelli, ‘New Views on the Optimum Currency Area Theory: What is EMU Telling Us?’ ECB Working Paper no. 138, 2002.

investors bailed out of Greek bonds, contagion spread to Ireland, Portugal, and Spain, where private sector lending had expanded exponentially on the back of asset booms in housing and construction, even though levels of public debt were relatively modest. In many respects, the problems in these countries paralleled those in the United States. But, unlike the U.S. or U.K., they did not have a central bank prepared to purchase sovereign debt. Instead, they began the torturous process of negotiating rescue programs with the ECB and EU.

**MANY OF THE PROBLEMS FACING
THE EU FLOWED FROM THE INSTITUTIONAL
ASYMMETRIES IN THE POLITICAL ECONOMIES
OF ITS MEMBER STATES**

Beneath the surface, however, the Euro crisis reflected some of the structural dilemmas of operating a single currency that encompassed multiple varieties of capitalism. The monetary union joined together states at different levels of political development and political economies structured in quite different ways. Many of the problems facing the union flowed not from the asymmetric economic shocks that optimal currency theory anticipated, but rather from institutional asymmetries in the political economies of its member states.⁸ The Stability and Growth Pact limiting public debt and deficits was hard to enforce and little more than a fig leaf covering these structural differences. Some believed that the experience of competing within a monetary union would gradually erase these institutional asymmetries, but they have deep historical roots that do not yield easily to incremental reform.

Among the most important differences in the organization of the political economy are those that distinguish the “coordinated market economies” of northern Europe, including Germany, Belgium, Austria, Finland, and the Netherlands, from the “Mediterranean” of southern Europe, including Spain, Portugal, Greece, and Italy.⁹ Germany is a classic example of these northern European economies. With well-developed trade unions and employers' associations organized along sectoral lines and accustomed to bargaining with one another, it has the capacity

8 A. Boltho and W. Carlin, “The Problems of European Monetary Union: Asymmetric Shocks or Asymmetric Behaviour?” <http://www.voxeu.org/article/problems-eurozone>.

9 P. A. Hall and D. Soskice, *Varieties of Capitalism* (Oxford: Oxford University Press, 2001).



Germany based its growth on export. In the image, the port of Hamburg.

to hold down unit labor costs in the interest of promoting exports. An elaborate system of vocational training operated by these producer groups and underpinned by works councils in large firms, gives German firms significant advantages in the production of high-quality and high value-added goods for which export demand is relatively stable. Like its northern neighbors, Germany was institutionally well-equipped to operate an export-led growth strategy.

By contrast, the political economies of southern Europe are organized quite differently. Spain, Portugal, Greece, and Italy developed fractious labor movements divided into competing confederations, which face relatively-weak employers' associations that allow for periodic social pacts but make sustained wage coordination difficult. As a result, under EMU, foreign competition held down wages in the export sectors, but rising wages in the sheltered sectors raised unit labor costs in the economy as a whole.¹⁰ These countries also lack the institutional capacities for coordinated skill formation that make high value-added production and continuous innovation more feasible. As a result, more of their firms relied on low-cost labor, and after 1989, their exports were hit hard by low-cost competition from East Central Europe.

10 B. Hancké, *Unions, Central Banks and EMU* (Oxford: Oxford University Press, 2013).

Monetary union had different implications for these two types of political economies. Inside EMU, the countries of northern Europe could pursue their longstanding export-led growth strategies. The ECB helped by keeping a close eye on German wage settlements, and Germany's neighbors targeted the latter to hold down their own wages. Moreover, they now enjoyed new advantages because their neighbors could no longer devalue against them, while the variegated membership of the union held down the external exchange rate of the Euro. As a result, the trade surpluses of northern Europe began to grow, in the case of Germany dramatically.

However, entry into monetary union posed serious dilemmas for the countries of southern Europe. In the years before Maastricht, without capacities for coordinating wage bargaining, they had often relied on periodic devaluations of the exchange rate to reduce the prices of their products vis-à-vis foreign competition. Under EMU, they lost this capacity for economic adjustment just when emerging economies began to eat into their market share for exports of low-cost goods. The alternative route to growth for these economies lay in the expansion of domestic demand. Entry into EMU rendered this strategy even more attractive because it lowered the cost of capital in southern Europe, as investors from the north sought sites in which to invest their growing trade surpluses. However, the natural concomitant to a growth strategy led by domestic demand is wage and price inflation, which the one-size-fits-all monetary policies of the ECB could not contain without precipitating recession in northern Europe. As inflation reduced the real cost of capital, asset booms drew resources away from export sectors already struggling with rising prices for inputs.

In short, one of the effects of monetary union was to encourage a set of unbalanced growth paths that saw the export sectors of northern Europe expand often at the expense of domestic consumption, while many export sectors in southern Europe languished alongside growing sheltered sectors, often dominated by construction. To blame these outcomes on southern European governments, as some do, is to ignore ineradicable differences in the organization of the political economies and the ways in which they provide countries with different types of adjustment mechanisms. For the most part, southern European governments pursued the growth strategies most available to them and often with considerable success. Between 1997 and 2007, Spain and Greece grew at rates close to 4 percent per year. More should have been

done to dampen construction booms and ensure the solvency of the banks funding them, but to expect southern Europe to have emulated the growth strategies of the north is to misunderstand how export-led growth is achieved.

**THE MONETARY UNION
ENCOURAGED UNBALANCED GROWTH
PATHS WHICH FAVOURED THE EXPANSION
OF EXPORTERS IN THE NORTH**

In the case of Greece, the structure of the polity was equally important to the origins of the crisis. Greek governments used flows of funds from the north to fund consumption rather than investment, often in order to shore up political support for the ruling party among public employees and pensioners.¹¹ Greece lacked the administrative capacities to collect and spend funds effectively: tax evasion may have accounted for half of the budget deficit reported in 2008. Clientelism was a problem elsewhere in southern Europe, as it is in parts of the north, but in Italy, Spain, and Portugal, product market regulation was reduced as much or more during the early 2000s as it was in most countries of northern Europe.

The Response to the Euro Crisis and its Consequences

The crisis of the Euro began in 2010 when international investors, already skittish as a result of the American banking crisis, lost confidence in the ability of European banks and sovereigns to repay their debts. The same herd instincts in the financial markets that had lowered the cost of capital in southern Europe suddenly raised its cost across much of the continent. In any circumstances, this would have been a difficult moment, but the single currency lacked any effective institutional mechanism for adjustment. Although the ECB gradually invented ways of providing emergency liquidity to banks under stress and finally restored confidence by announcing in mid-2012 that it was willing to buy sovereign debt on the secondary markets, initially, it was unable

¹¹ M. Mitsopoulos and T. Pelagidis, *Understanding the Crisis in Greece* (Houndmills: Palgrave Macmillan, 2012).

to purchase government bonds in order to stave off panic in sovereign debt markets. A Eurozone built only on a minimalist set of rules had no centralized fiscal capacities of its own and limited abilities for decision-making, which depended on reaching unanimity among its member governments.

**WITH THE RESCUE, GERMANY WAS
ENSURING THAT LOANS MADE BY ITS OWN FINANCIAL
INSTITUTIONS WOULD BE REPAYED**

In this context, the fact that European governments were eventually able to assemble rescue packages for the Greek, Irish, and Portuguese governments, as well as a credit line for Spanish banks, is a striking achievement, reflecting unprecedented levels of intergovernmental cooperation. Paradoxically, however, the torturous process whereby that cooperation was secured put strains on the European system of governance that threaten the prospects for further European integration in the coming years.

The initial fateful choices concerned Greece, which was running out of money in 2010 and unable to borrow at affordable rates on international bond markets. Runaway public spending over the previous decade had fueled rapid rates of economic growth but taken public sector deficits and debt to dangerously high levels. Its partners in the Eurozone faced a choice. They could organize a restructuring that would see Greece default on much of its debt, perhaps accompanied by some financial support to ease the pain as the country moved toward a primary surplus. Or, they could lend Greece the funds to continue making payments on its debt in return for promises of reform designed to bring the country back to fiscal stability.

Neither option was an attractive prospect. In either case, the Greek people would suffer greatly as the government cut spending to eliminate a deficit worth 12 percent of its GDP. Prominent economists urged restructuring on the grounds that it was the best way to cope with a debt crisis and best done early. Some argued that adjustment would be more successful if the country also left the Euro and devalued its currency rather than rely entirely on internal deflation to reduce real wages to internationally-competitive levels.

However, the member states of the European Union chose the alternative route, assembling two bailout packages, in May 2010 and July

2011, which provided the Greek government with about €225 billion in return for its adherence to stringent conditions designed to reduce its outlays and increase its revenue in order to improve the prospects that the funds would be repaid. A third loan, worth about €86 billion, followed in 2015. Historians will long debate why this path was chosen over the default. Amidst the uncertain financial circumstances of 2010, governments were clearly concerned about the possibility of contagion. If a state within the single currency had defaulted, it might have become more difficult for other members to fund their national debts, including Italy, an economy too large to rescue. Moreover, the Greek default would have created serious problems for the European financial system, since large segments of Greek debt were held by northern European banks. If the other governments had not rescued Greece, they would likely have had to rescue some of their own banks. As a result of the bailout, those banks eventually recovered more than €70 billion lent to Greece.

Following the Greek precedent, another bailout of approximately €85 billion was provided to Ireland, in November 2010, and one of €78 billion to Portugal, in May 2011, followed by a credit facility on which Spain drew for €41 billion to recapitalize its troubled banks. These funds were granted only on stringent conditions specifying limits on fiscal deficits and structural reforms to liberalize various labor or product markets. At the insistence of the ECB, Ireland was prohibited from writing down the debt bondholders held in the failing Irish banks. The ostensible objective was to sustain confidence in European financial markets, but the effect was again to limit the penalties paid by the private sector for making risky loans and to transfer the costs of resolving the crisis onto the public sector.

Many commentators, especially in the northern European media, presented these bailout programs as acts of unprecedented largesse. Led by Germany, the north was said to have come to the rescue of the south, allowing indebted countries to avoid the perils of default. In hindsight, however, judgments about what happened must be more nuanced. Germany was sustaining a single currency that had been of benefit to its export sectors and was ensuring that loans made by its own financial institutions would be repaid. Moreover, the approach taken to these bailouts had unfortunate economic and political consequences that will haunt Europe for some years to come.

The negative economic consequences are most evident in the case of Greece, although there are some parallel features in the treatment

of Portugal and Ireland as well. Greece suffered a classic debt crisis as a result of profligate public spending and inadequate systems for tax collection. While fiscal cutbacks are necessary in the wake of such a crisis, experiences of other debt crises suggest that countries will emerge from them only if most of the debt is written off, inflation reduces the real value of the debt or a revival of economic growth reduces the scale of the debt relative to GDP.¹² In the opening years of the crisis, however, the European response ruled out each of these alternatives.

The policies of the ECB and global economic circumstances militated against inflation, and the rescue packages of the EU initially ruled out writing off the debt. Although Greek debt was written down by a large amount, equivalent to two-thirds of Greek GDP in March 2012, this initiative came too late to offer adequate relief. Thus, the capacity of Greece to emerge from the crisis has depended largely on its capacity to grow economically. But the terms of the bailout programs specified such high levels of fiscal austerity that economic growth became virtually impossible. These programs required Greece to move from a 15 percent fiscal deficit to a 3 percent primary surplus within the space of three years, something few other countries have ever accomplished. Time and time again, the rosy projections for growth offered by the troika (the European Commission, ECB, and IMF) supervising the bailout conditions proved illusory. By 2015, Greek GDP remained 25 percent below its level in 2009. The loans offered to Greece were not sufficient to allow it any sort of fiscal stimulus: 90 percent of those loans went to pay the interest and principal due on existing loans. There was no room left to support aggregate demand in the context of deep cuts to wages and social benefits. As gross domestic product shrank, Greek debt as a proportion of GDP grew ever larger, further reducing confidence in the economy.

The response of the creditor governments to such concerns has been to emphasize the value of the structural reforms to liberalize product and labor markets imposed on Greece as a condition of the bailout. Some of those reforms are likely to have desirable effects on economic performance, but only in the long run. In the short run, structural reforms undertaken in the context of fiscal austerity often have negative effects.¹³

12 C. M. Reinhart and K. F. Rogoff, *This Time is Different* (Princeton: Princeton University Press).

13 B. Eichengreen, "How the Euro Crisis Ends: Not with a Bang but a Whimper," *Journal of Policy Modeling* 37 (2015): 415-22.

The suggestion that they could be the basis for a revival of economic growth was a mirage.

Why then did the creditor countries of northern Europe insist that structural reforms in the context of fiscal austerity were the best basis for growth? To some extent, this stance was simply pragmatic politics. The creditors were already lending Greece sums equivalent to its total annual GDP. To reduce Greek deficits more slowly in order to revive the economy, higher levels of lending would have been required, and the creditor governments worried about an electoral backlash, especially amidst multiple *Länder* elections in Germany in 2011. Structural reforms were seen as a priority because the roots of Greece's problems were widely ascribed to the clientelist politics of an overly-regulated economy.

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Such views had resonance in northern Europe because they conformed to the modes of macroeconomic management that worked best there. In coordinated market economies operating an export-led growth strategy based on high levels of inter-sectoral wage coordination to hold down unit labor costs, a restrained macroeconomic stance is desirable because it reduces the incentives of trade unions and employers to exceed desirable wage norms.¹⁴ Moreover, Germany had developed an approach to economic policy-making that foreswore activist government in favor of the promulgation of rules, in which coordination among well-organized producer groups was to take place.¹⁵ However, as I have noted, the organization of the southern European economies does not lend itself to export-led growth strategies of this type. In their case, economic growth depends more heavily on the expansion of domestic demand.

Accordingly, economic growth is returning to Ireland, whose liberal market economy, oriented toward foreign direct investment, which is

14 W. Carlin and D. Soskice, "German Economic Performance: Disentangling the Role of Supply-Side Reforms, Macroeconomic Policy and Coordinated Economy Institutions", *Socio-Economic Review* 7 (2009):, 69-99.

15 P. A. Hall, "Varieties of Capitalism and the Euro Crisis," *West European Politics* 37 (2014):, 1223-43.



The European Central Bank.

attracted by favorable tax treatment and a skilled, English-speaking population, has been buoyed by a resurgence in global demand. But growth remains elusive in southern Europe where multiple years of austerity have taken a toll on productive capacity and levels of investment. Spain is growing again but at rates not yet high enough to reduce an unemployment rate close to 25 percent, and growth remains sluggish in Portugal where the unemployment rate is close to 15 percent. In Greece, 26 percent of the workforce is still unemployed despite a decline in nominal wages of 25 percent since 2009. The bailout program has left it floundering in political as well as economic terms. In retrospect, it looks as if it would have been better if the country had been allowed to restructure its debt in 2010 and given aid designed to ease its transition toward a primary surplus rather than focused on paying back lenders. Such an approach would have imposed a larger share of the adjustment costs on European financial institutions (and those who invest in them) but potentially lower levels of suffering on the Greek people.

The response to the Euro crisis also laid bare a series of political paradoxes consequential for the future of European integration. In the context of coping with the crisis, the heads of government of the Eurozone met together or with other EU leaders an extraordinary fifty-four times between January 2010 and August 2015. On the one hand, these high-level meetings reflected unprecedented levels of consultation and

cooperation among the member states. On the other, this *modus operandi* sidelined the Parliament and Commission, institutions that were supposed to gain influence under the Treaty of Lisbon, in the name of advancing European democracy. Just when it was supposed to become more democratic, the EU began to look more technocratic, and the “troika” seemed to some as if it were operating like an imperial power.

The crisis years have also been marked by the ascendance of Germany to a position of virtual hegemony with the councils of the EU, a paradoxical result given that France initiated the move to EMU partly in order to reduce German influence over European economic affairs. Although it was inevitable that a reunified Germany would gradually become more willing to assert its national interests because it paid the largest share of the bailout bills, the Euro crisis rapidly thrust it to prominence and power, arguably before the German government had time to reflect carefully about how to balance national and European interests. In many respects, Germany is a reluctant hegemon—less willing to pay the costs of providing public goods for a large number of states than the U.S. was when it assumed that mantle after World War II. In the coming years, much will depend on what Germans think their leadership role in Europe entails.

In another paradoxical result, a crisis that ultimately called forth intensive cooperation among the political elites of the member states has ended up fostering hostility among the citizenry at large. In the wake of the crisis, a wave of popular stereotypes poured forth from the media, rooted on images of “lazy Greeks” and “jackbooted Germans.” As a result, it is clearer than ever before that social solidarity in Europe currently stops at national borders. Political leaders bear some responsibility for this state of affairs. The initial response of many northern European politicians was to treat the crisis not as the existential dilemma that it was for Europe, but as a moral issue about whether the citizens of other countries had been adequately self-disciplined. When Syriza took office in Greece, it was repaid by accusations that the Germans were behaving like Nazis. Sentiments such as these have eroded the sense of transnational solidarity on which electoral support for effective cooperation within the EU depends.

The most serious issues raised here bear on the EU’s commitment to democracy, for which it was awarded the Nobel Peace Prize in 2012. The extensive conditions attached to its bailout agreements, and policed by the troika, have often been forced on reluctant national governments,

notably in Ireland, which was forbidden from imposing a haircut on the holders of bonds in its failing banks, and in Greece, where the troika dictated highly-detailed sets of spending, tax, and industrial policies. The reasoning, of course, is that European officials know better than their national counterparts how to secure the growth necessary to pay back substantial European loans, and there are precedents in the conditions imposed by the IMF on debtor countries. But the European Union has pretensions to democratic governance that the IMF does not, and many wonder why it could not have negotiated a required level for budget surpluses in the debtor countries while leaving the decisions about how to meet those levels to elected governments. This new assertiveness is gradually altering the relationship between the EU and its constituent states. The commitment to principles of “subsidiarity,” which it once advanced in order to guarantee the political autonomy of its members, has dissolved in the face of an overweening enthusiasm for imposing “structural reform” on them.

The Future of the Euro and European Integration

In this context, the most pressing issue is whether the single currency can endure and operate successfully without deeper political integration. Among the European political elites, there is currently a strong impetus to centralize economic power in Brussels. Many in the north want to give the EU more substantial powers over national budgets in order to avoid a repeat of the fiscal foibles that brought Greece to the brink of bankruptcy. Politicians from the south are more likely to argue for an economic government equipped with new sources of funding and the capacity to promote reflation in Europe. They are supported by many economists who argue that the single currency will survive only if the Eurozone moves toward this type of fiscal union with supervisory powers over national budgets and ideally with a budget of its own to provide the social insurance benefits that might cushion the member states facing recession from such shocks.¹⁶

The capacities to decide whom to tax and how to allocate the proceeds, however, are the most important powers of a democratic state.

16 H. Enderlein et al., “Completing the Euro – A Roadmap towards Fiscal Union in Europe,” Report of the Tommaso Padoa-Schioppa Group, Notre Europe Study no. 92 (2012).

As William Gladstone once said, “Budgets are not merely matters of arithmetic, but in a thousand ways go to the root of prosperity of individuals, and relations of classes, and the strength of Kingdoms.” To pass budgetary powers on to Brussels might be economically efficient, but it is hardly democratically legitimate. Accordingly, many observers have argued that a Eurozone authority equipped with such powers must be democratically governed, and diverse sets of schemes for doing so have been produced, including proposals to elect the President of the Commission and to strengthen greatly the powers of the European Parliament. On this view, deeper fiscal union requires a political union based on the development of more democratic European institutions.¹⁷

**IT IS DIFFICULT TO SEE WHERE THE POPULAR
SUPPORT NECESSARY TO ALTER THE EUROPEAN
TREATIES SO AS TO BUILD NEW EUROPEAN
INSTITUTIONS WOULD COME FROM**

However, none of these schemes for turning the European Union or its Eurozone into a supranational democracy are really viable. In the absence of effective competition among genuinely European political parties, even the most ambitious schemes for making European institutions more democratic offer, at best, highly tenuous lines of electoral accountability, and, in the wake of the Euro crisis, popular support for passing more powers to Brussels is at a low ebb. Majorities in most European electorates continue to favor the Euro and membership in the EU, but enthusiasm for further political integration has declined, and radical right parties opposed to European integration are on the rise across Europe.¹⁸ In the foreseeable future, it is difficult to see where the popular support necessary to alter the European treaties so as to build new European institutions would come from in either southern or northern Europe.

Moreover, the torturous negotiations accompanying the Euro crisis have worn away the sense that the single currency is a positive-sum enterprise offering manifest benefits to all. Because those negotiations

¹⁷ J. Habermas, *The Crisis of the European Union* (Cambridge: Polity, 2012); M. Matthijs and M. Blyth, eds., *The Future of the Euro* (New York: Oxford University Press, 2015).

¹⁸ Pew Research Center, *European Unity on the Rocks* (Washington: Pew Research Center, 2012).

have been dominated by a search for national advantage, as well as endemic conflict between the ECB and European governments about which would bear the risks associated with new initiatives, the response to the Euro crisis has looked like a zero-sum enterprise in which the risks or costs of new initiatives are borne more heavily by some actors than others. As a result, it has become more difficult to argue that further European integration is an enterprise from which all the member states will gain.

**THE EUROZONE MAY BECOME LOCKED INTO
A DEFLATIONARY MACROECONOMIC STANCE THAT
CONDEMNS SOME OF ITS MEMBER STATES TO SLOW RATES
OF ECONOMIC GROWTH FOR YEARS TO COME**

Therefore, the EU finds itself on the horns of a dilemma. Influential figures are arguing that the single currency will survive only if the Eurozone has an economic government of its own. But, since there seems no way of making such a government truly democratic, moves in this direction threaten to replace embryonic democratic institutions with a new technocracy. Caught between Scylla and Charybdis, the member states are currently temporizing. With a fiscal compact committing the member states to budgetary balance and new regulations for the supervision of national budgets, the European authorities have acquired unprecedented powers of purview over national budgets, but it remains unclear whether those powers will ever really be exercised.

Moreover, a fiscal compact that marries a “one-size-fits-all” fiscal policy to the “one-size-fits-all” monetary policy of the single currency is not a recipe for economic success. As I have noted, because the political economies of the member states are organized in different ways, they cannot all emulate the export-led growth strategies of Germany. Some can prosper only via demand-led growth strategies that require more relaxed fiscal policies. The clear-cut danger is that the Eurozone may become locked into a deflationary macroeconomic stance that condemns some of its member states to slow rates of economic growth for years to come.

In this respect, institutional reform will not in itself solve Europe’s economic problems. The important issue is what sorts of decisions would emerge from any new set of European institutions, and those decisions will depend on the relative power and positions of the national states represented there. A new set of institutions dominated by

a German government convinced that the budgets of every member state should always be balanced (and that trade surpluses reflect virtue while deficits result from vice) might yield policies no more conducive to growth than the current ones. Macroeconomic coordination at the European level will not be successful until those supervising it realize that there is more than one route to economic success.

Does this mean that, if the member states of the Euro do not move closer to fiscal and political union, the single currency is doomed to disintegrate? Not necessarily. The Eurozone does not yet have robust institutional mechanisms for economic adjustment. But it is arguable that, with a slightly more-developed institutional exoskeleton built on recent practice, the single currency may be able to endure.¹⁹ Based on the experience of the Euro crisis, national governments may be more careful about letting public or private sector debt balloon beyond control and, if yields in sovereign debt markets become more responsive to such developments, they will have more incentives to do so. One key condition for economic success is a robust banking union capable of identifying and winding down insolvent banks so as to maintain transnational financial flows. Although stalled on the issue of cross-national deposit insurance and equipped with a bank resolution fund that is currently too small, plans for such a banking union are proceeding.

Another condition underlined during the Euro crisis is the presence of a European central bank with the capability to act as a lender of last resort both to banks and to sovereigns in order to deter speculative attacks in the financial markets. Although it is still formally enjoined from purchasing sovereign debt, the ECB has moved in this direction over recent years with its program of outright monetary transactions (OMT) backed by an announced resolve “to do what it takes” to preserve the Euro. Much depends on whether these practices are accepted as legitimate modes of operation going forward, and it is conceivable that they might be.

From my perspective, the key issue is whether the single currency can be sustained even if some member states run endemic deficits on their current account while others run persistent surpluses, since the presence of multiple varieties of capitalism inside the Euro makes that likely. In principle, this need not be a problem: after all, some states in

¹⁹ For an argument to this effect, see D. Soskice and D. Hope, “The Eurozone and Political Economic Institutions: A Review Article,” in preparation for the *Annual Review of Political Science* (2016).

the American currency union run endemic deficits or surpluses vis-à-vis one another. For that to be possible, investors in the states that acquire funds by running surpluses must be willing to invest some of those funds in states running deficits. A banking union offering reinsurance about the solvency of counterparties helps make that possible. However, the growth prospects of the states running deficits must also look good enough to justify such investment. Thus, the fate of the Euro hangs to some extent on future prosperity in southern Europe.

In previous decades, a catch-up process that leads countries at lower levels of economic development to converge toward the standard of living of those at higher levels of development has provided incentives for investment in southern Europe. The Euro crisis has disrupted that process, and investors will be more wary about the types of asset booms that appeared over the last ten years. Therefore, much will depend on the capacity of the states on the southern and eastern boundaries of Europe to generate growth in new ways and, in particular, to move towards the production of higher value-added commodities in the context of global markets where the comparative advantages for low-cost production lie elsewhere. That will require, in turn, that these countries adjust to the modalities of an emerging knowledge economy.

To date, the record of southern Europe on these fronts is spotty. Except in some regions, levels of vocational training and tertiary education lag behind those of northern Europe, and spending on research and development is at relatively low levels. But there is opportunity for improvement to be found here. The larger lesson is that the survival of the Euro and the prosperity of much of the continent will depend not simply on the short-term decisions taken about how to survive the crisis, but on the decisions that are made in the countries of southern and eastern Europe about how to invest in the levels of human capital and infrastructure that will position them for effective long-term growth.

In this regard, the future of Europe lies as much in the hands of national governments as it does in extended European cooperation. In many parts of Europe, the public evinces lower levels of trust in national governments than it does in the European Union, and there is corresponding turmoil in national politics.²⁰ Whether political coalitions capable

20 J. Frieden, "The Crisis, the Public and the Future of European Integration." Paper presented to a conference on Transition and Reform: European Economies in the Wake of the Economic Crisis, Lisbon, May 2015.

of constructing effective national growth strategies can emerge from that turmoil remains to be seen. But, provided Europe gives its member states adequate room for maneuver, this is not an impossible dream.

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