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Will It Be Brussels, Berlin, or Financial Markets that Check Moral Hazard in Europe's Bailout Union? Most Likely the Latter!

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I. INTRODUCTION

> "The government of the Union is neither in a legal nor a moral sense bound for the debts of the states, and it would be a violation of our compact of union to assume them…"
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> —*James Knox Polk, 11th President of the United States, Inaugural Address March 4, 1845*[1]

So far so good for the European Union in preventing the Greek sovereign debt crisis from spiraling out of control in the short term. But with Greece in May 2010 requiring an unprecedented bailout from the European Union/IMF to avoid immediate default and 25 of the European Union's 27 member states currently subject to an "excessive deficit procedure" (European Commission 2010i), it remains evident that the European Union's existing fiscal surveillance framework patently failed both before and during the Great Recession and that Europe's leaders must head back to the drawing board for a required long term reform of the EU fiscal policy and surveillance framework.[2]

This reform process has already begun on multiple tracks in Brussels and elsewhere.[3] On June 30 and September 29 the European Commission published a comprehensive package on enhancing European economic policy coordination (European Commission 2010a–g) and on July 9 the European Central Bank (ECB) presented its set of recommendations for institutional changes in the EU fiscal policy framework.[4] Meanwhile, a final report from the Task Force on Economic Governance headed by the president of the EU Council, Herman van Rompuy, on the same set of issues will be presented at the EU Council in late October 2010. As such, a future reform of the EU fiscal surveillance framework is likely no later than at the final European Council meeting this year in December.

This policy brief will argue that the Greek bailout introduces an unprecedented degree of moral hazard[5] into the European Union and the eurozone in particular, which will require multiple political mechanisms to keep it in check and prevent it from undermining public confidence in the

1. See Polk (1845).

2. See Kirkegaard (2010a) for an overview of the European Union's early crisis response.

3. The EU Council in its conclusions on March 25, 2010, started this process, which is scheduled to conclude before the end of 2010. See EU Council (2010).

4. See four speeches by ECB Governing Council members on July 9, 2010. Available at www.ecb.europa.eu/home/html/index.en.html.

5. This policy brief will follow the broad definition of moral hazard as "any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly" from Krugman (2000) and apply it at the level of sovereign state actors.

European Union more broadly.[6] At least three mechanisms, of which only one has currently been implemented, are required to check moral hazard in Europe going forward: strict ex post conditionality attached to bailouts (in place), strict ex ante fiscal rules in a reformed Stability and Growth Pact (SGP) and a "eurozone orderly sovereign debt restructuring mechanism (E-SDRM)."

The fact that bailouts now are an option inside the eurozone produces a new and critical concern for the broader EU institutional framework—moral hazard.

This policy brief will further argue that the longer-term reform of the EU fiscal policy framework and the SGP in particular takes place in a postcrisis Europe economic and political reality in which Germany has been greatly empowered. With large-scale new integrationist measures politically impossible in Europe, but moral hazard introduced through the new precedent of eurozone bailouts, the European Union will have no choice but to, along German demands, implement reforms aiming for a far more fiscally disciplined Europe.

II. THE LONGER-TERM IMPLICATIONS OF THE GREEK BAILOUT

The fact that bailouts now are an option inside the eurozone produces a new and critical concern for the broader EU institutional framework—moral hazard. This issue could precrisis conveniently be assumed away by policymakers through the existence of the "no bailout clause." After the Greek bailout, this is no longer possible. Instead, practical measures must be taken to prevent eurozone governments from succumbing to the short-term temptation of running perhaps electorally popular, but ultimately unsustainable economic and especially fiscal policies.

When the euro was introduced in the late 1990s, the rationale presented for the politically binding SGP constraints on member states' fiscal autonomy to prevent overborrowing was that this was necessary to preserve the stability of the common currency.[7] This was essentially a German "anti-inflation argument," since the EU Treaty's (in theory at least) explicit "no bailout clause" was assumed to rule out the kind of "direct government-to-government bailout" that was ultimately granted Greece.[8] The concern was instead that excessive government debts would force the ECB to monetize such debts and that inflation would ensue.

Yet as the direct government-to-government bailout granted to Greece in May 2010 occurred in the midst of a global economic crisis with low capacity utilization, large output gaps, and high unemployment rates across the eurozone (European Commission 2010b), it has had no inflationary impact and seems extremely unlikely to in the future. The same is true for the associated actions of the ECB. The small and (almost) wholly sterilized Securities Markets Program (SMP) has no inflationary impact in Europe, while in fact the direct government bailout of Greece limits the immediate risk of excessive deterioration of the asset quality of acceptable collateral for market transactions with the ECB, as well as similarly reducing the riskiness of SMP purchases of peripheral sovereigns' debt.[9] As such, contrary to many concerns in Germany, the 2010 Greek bailout and related ECB actions will not result in higher inflation in the eurozone and hence for at least that reason do not warrant a "toughened-up SGP."

However, the direct government-to-government Greek bailout instead produces a different and more important reason for Europe to put more teeth into the postcrisis successor to the SGP. The risk of moral hazard from any type of bailout is well known, but as will be elaborated below when dealing with sovereign actors an additional set of concerns arises related to public opinion in the countries involved.

First though, how the events related to the Greek sovereign debt crisis in the spring of 2010 have had lasting effects on the political circumstances surrounding EU fiscal surveillance must be laid out. Three key issues bear mentioning here:

The Precedent for "Conditional EU Bailouts" Has Been Set

Originally the "no bailout clause" in the EU Treaty was imagined, in times of relative global economic calm, to prevent the transfer of a single fiscally irresponsible member's liabilities

6. This policy brief is loosely based on postings by the author on the Peterson Institute RealTime Economics Issues Watch during the summer of 2010, where they benefited greatly from the advice of Steve Weisman. RealTime is available at www.piie.com/realtime.

7. See for instance von Hagen (1991), Buiter, Corsetti and Roubini (1993), de Grauwe (1994) and Eichengreen and von Hagen (1995).

8. The European Financial Stability Facility (EFSF) consists of pooled bilateral loan guarantees from all of the eurozone members, and as such is functionally the near equivalent of a jointly issued Eurobond.

9. The ECB has further introduced a new set of risk control measures in its framework for eligible collateral, including a series of haircuts for lower quality assets. See http://www.ecb.int/press/pr/date/2010/html/sp090728_1annex.en.pdf?bbe012c6ad9bb6d4b1991269a2b19826.

to other fiscally more responsible members.[10] As it turned out in 2010, definitely the spirit, if not the letter of the "no bailout clause" was broken in the midst of the Greek sovereign debt crisis, as it threatened to spread to several other eurozone countries.

Considering that it is next to impossible in a closely integrated but aging eurozone with relatively low future potential growth rates to imagine a scenario where another single member could slide toward default without other members being affected by contagion in a broadly similar manner as in the spring of 2010, future bailouts now seem unavoidable. In any game of "bailout chicken" with a default-threatened member and financial markets, other eurozone governments will inevitably blink first.

Simply put, no eurozone member will ever be allowed to enter into a "sudden disorderly default." Making an analogy to the recent banking crisis, all sovereigns in the eurozone were found to be "too big to fail," at least in a disorderly manner that risked contagion.[11] At the same time, it should be recalled that larger members of the eurozone may simply be "too big to bail out" as basic feasibility concerns must inevitably continue to be addressed on a case-by-case basis when bailouts of larger eurozone members are discussed. "Political automaticity" in bailouts of eurozone members therefore relates principally to small members like Greece (Portugal or Ireland).

The fact that, despite earlier insisting on having both a "no bailout clause" and the SGP, German parliamentarians have now overwhelmingly backed the Greek bailout and the creation of the European Financial Stability Facility (EFSF) supports this conclusion. Irrespective of what the German Constitutional Court ultimately rules with respect to the legality under German law of the German government's participation in both the Greek bailout and the subsequent creation of the EFSF, it will not change the fact that an overwhelming majority of the German parliament approved hereof in early May 2010. Only the left-wing Linke Party, with a little more than 10 percent of the total vote in the recent German elections, opposed the bailout.[12]

The presence of an overwhelming majority in favor among Germany's elected parliamentarians can hardly pass unnoticed by the appointed judges on the Constitutional Court as they consider their verdict. In any case, though, this majority virtually ensures that the German government and parliament can find a way around any adverse ruling, despite the ruling coalition's loss of the German Upper House majority in regional elections in May 2010.

Yet at the same time as a bailout precedent has now been set, it is equally clear that the Greek rescue package was, as well as future similar bailouts will be, subject to stringent conditionality.

The broad political consensus in Germany concerning the country's participation in the official sector bailout of Greece—a country that through things like its cooked government books and bizarrely low retirement ages seems, in a political sense, uniquely undeserving of any outside assistance—clearly establishes the political precedent that eurozone members finding themselves in acute fiscal problems in the future will also be rescued. After the Greek bailout, probably only a eurozone country that suddenly declared war on a neighbor (and thereby got into fiscal trouble the same way most countries historically have) could be considered ineligible.

Yet at the same time as a bailout precedent has now been set, it is equally clear that the Greek rescue package was, as well as future similar bailouts will be, subject to stringent conditionality. The fact that Greece is now essentially undergoing a standard IMF program to qualify for EU/IMF funds means that the bailout agreed in the spring of 2010 is probably the best thing that has ever happened to promote structural economic reforms in Greece.

Irrespective of whether Greece will ultimately have to restructure its debts or not, the country will, as a result of the IMF program, have eliminated a host of unsustainable social and economic institutions, most noticeably its erstwhile disastrously

10. Article 125 in the Consolidated EU Treaty reads: "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any member state, without prejudice to mutual financial guarantees for the joint execution of a specific project. A member state shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another member state, without prejudice to mutual financial guarantees for the joint execution of a specific project." See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:EN:PDF.

11. Note how General Motors, while bailed out initially by the US federal government at the height of the financial crisis in late 2008 was ultimately allowed to go into bankruptcy when financial markets were more calm in the spring of 2009. Similarly, it cannot at this point be ruled out that Greece will ultimately restructure on its debts at some point in the future, despite its initial bailout in May 2010.

12. As discussed in Kirkegaard (2010b), the Social Democratic Party of Germany abstained from the vote, but only due to the insufficient "private sector banking participation" (i.e., the absence of bailing in private creditors) in the proposal.

designed pension system.[13] This is unambiguously a long-term positive for the Greek and broader European economy.

While reform-shy policymakers in Europe may therefore now look forward to ultimately receiving a bailout from the European Union/IMF, it will invariably take the form of a politically poisoned chalice entailing that they will lose a substantial amount of sovereignty and have to undertake precisely the kinds of structural reforms previously avoided only now in an expedited manner under the guidance of the IMF.[14]

In establishing the precedent for bailouts in Europe, the first mechanism to limit related moral hazard was therefore also entrenched.

Intra-Eurozone Bond Spreads Will Be Permanent and Germany Is Now the Eurozone Safe Haven

Membership of a monetary union by definition eliminates the possibility of individual governments receiving market price signals regarding their longer-term relative economic performance from the exchange rate of a national currency. In the precrisis eurozone of very closely converging government bond yields, there were similarly no "market price signals" to governments from the bond markets. This artificial insulation of eurozone governments from market signals, however, dramatically changed after the beginning of the global economic crisis. This is illustrated in figure 1 with 10-year government benchmark bond yields for selected eurozone members and Germany from Jan 1, 2008.

Figure 1 shows how spreads began to widen between Germany and the weaker eurozone countries when the global recession reached Europe following the collapse of Lehman Brothers in September 2008. Intra-eurozone spreads continued to widen during the first panic phase of the crisis, as peripheral eurozone sovereigns began acknowledging the fiscal effects of required bank rescues, housing market corrections, and economic recessions.

During the first nine months of 2009, a gradual narrowing took place, until the announced upward revisions of Greece's deficit data in October 2009 started the second "sovereign phase" of the European economic crisis. As the Greek sovereign crisis turned acute in early May 2010 and threatened to spread to other eurozone members, German 10-year bond yields fell to historic lows and significant and sustained spreads opened up to all other weaker eurozone economies and even to French bonds. The worse Europe's economic and sovereign debt crisis has become, the more powerful has been the effect of Germany's new "safe-haven status."

In an aging Europe, where future demographic trends will severely restrict opportunities for countries to simply grow out of their elevated postcrisis debt levels, and where weaker eurozone members—noticeably Ireland, Spain and Portugal—have gradually (and belatedly) lost their top-notch credit ratings and all face serious questions regarding their long-term growth prospects, Germany's new safe haven status among at least euro-denominated assets looks likely to become entrenched.

Given the longer-term economic outlook for Europe, irrespective of what reforms will be made to the SGP, European government bond markets are unlikely to fall back into their dangerous precrisis lull. While markets can remain irrational for very long periods of time and for instance gravely misprice eurozone government bonds for a decade until September 2008, upon realizing such a mistake they very rarely make the same mistake again.

Direct price signals from the bond markets to eurozone governments will remain and any future eurozone bond yield convergence seem likely only as the result of a convergence of underlying economic fundamentals toward a more sustainable debt outlook. Just as financial markets up until the collapse of Lehman Brothers and the revelation of the true state of Greek public finances gave eurozone governments the opportunity to ignore longer-term economic sustainability concerns, the financial markets have now taken away this opportunity. Europe has therefore gained from this crisis an important and hitherto missing long-term progrowth promoter, as higher bond yields have proven very effective at forcing recalcitrant EU governments to "bite the bullet" on required structural reforms.

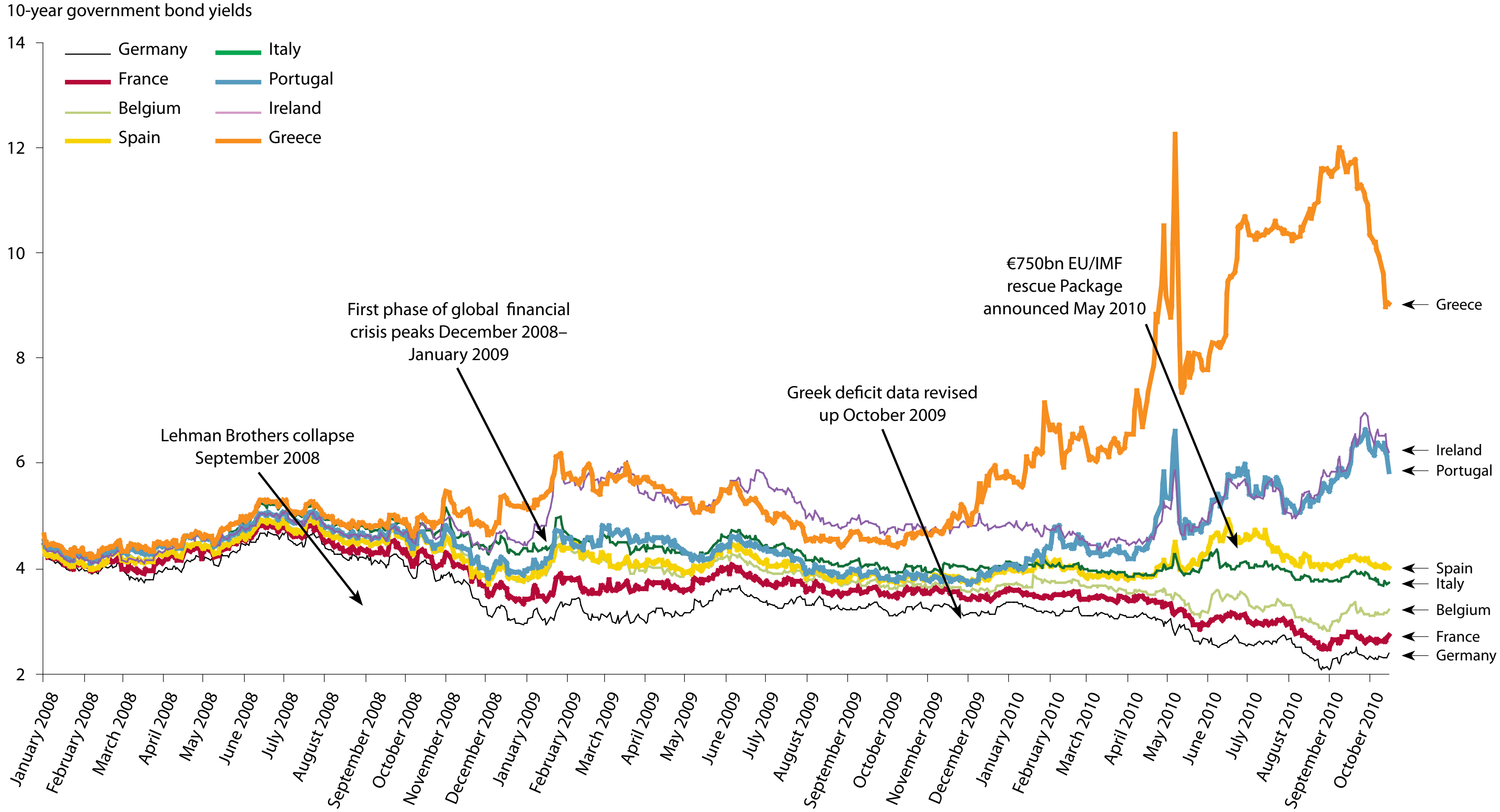
The Greek Demonstration Effect

Thirdly, events in Greece have now shown EU voters just what can happen if governments run unsustainable fiscal policies for too long and they clearly don't like what they have seen. Political platforms of fiscal austerity have triumphed in all national EU elections (held in the Netherlands, Slovakia, the UK and remarkably even crisis-stricken Latvia) since the start of the Greek crisis, and recent polls in the large EU countries similarly point to very significant public support for fiscal

13. The Greek parliament on July 8 approved an EU/IMF-dictated overhaul of its public pension system that will entail cuts to pension benefits, introduce severe penalties for early retirement, increase the statutory retirement age by up to 10 years to 65 for both men and women, increase required contributions, and change the formula for the calculation of pensions. See Paakkinen (2010).

14. EU leaders were very clear when setting up the EFSF (€440 billion) that "Its activation is subject to strong conditionality, in the context of a joint EU/IMF support, and will be on terms and conditions similar to the IMF." As such, 100 percent IMF conditionality on any future EU funds committed is assured. See ECOFIN Council (2010).

Figure 1 Euro area 10-year sovereign bond yields January 2008–October 2010



Note: 10-year benchmark bond bid yields.

Source: Datastream.

austerity measures.[15] Most remarkable is the recent reelection of the Latvian government, which occurred after an approximately 20 percent decline in GDP per capita levels.[16] Hence, even large and rapid "internal devaluations" in the eurozone (and associated countries like Latvia) should correspondingly not be ruled out as "politically impossible."

In summary, the three key longer-term effects of the Greek debt crisis are therefore that conditional bailouts will happen in Europe; that Germany is now the eurozone safe haven once again benefitting from lower interest rates than other members; and that running fiscally unsustainable policies has become more politically costly in Europe.

This suggests that the "demonstration effect" arising from Greece's problems has raised the domestic political costs for European governments of running unsustainable fiscal policies considerably. Future serial offenses against reformed EU fiscal rules due to individual member states' lax budgetary policies (i.e., unrelated to a dramatic global economic slowdown and financial crisis as seen in 2008–10) consequently seem less likely.

This trend toward a more lasting political consensus about fiscally sustainable policies is moreover strengthened by the abandonment—as a result of the economic crisis—of traditional "looney left" economic policies, e.g., things like excessively low retirement ages and rigid Employment Protection Legislation (EPL), by the mainstream Southern European center-left parties. The belated embrace (under the watchful eye of bond markets and, in the case of Greece, overseen by the forceful arm twisters of the IMF/European Union) of more promarket "supply side" social policies, guided by individual incentives and aimed at reducing government spending, by the ruling Spanish socialist party PSOE, the Portuguese PS, and of course Greece's socialist PASOK, mirrors the shift to the political center on economic policies undertaken by Northern Europe's social-democratic parties in the 1980s and 1990s.[17]

What this means is that for the first time in Southern Europe—and broadly similar to the situation in the recent decade in Northern Europe— there will be a centrist majority broadly in favor of fiscally sustainable policies comprising the mainstream center-left and center-right parties. Despite the likely strengthening of the two political extremes as a result of this mainstream center-left shift to the center on economic policies, in Southern Europe's proportional representation political systems, which (unlike closed primary elections in the United States) tends to leave political extremes outside any influence, the new electoral majorities in favor of fiscal austerity will prove lasting.[18]

In summary, the three key longer-term effects of the Greek debt crisis are therefore that conditional bailouts will happen in Europe; that Germany is now the eurozone safe haven once again benefitting from lower interest rates than other members; and that running fiscally unsustainable policies has become more politically costly in Europe.

III. THE NEW NEED FOR ENHANCED EX ANTE FISCAL DISCIPLINE

In a eurozone where repeated direct government-to-government bailouts are probable, without new counter-measures governments that now know they are likely to be bailed out by other members of the monetary union[19] even if they pursue reckless fiscal policies may be more prone to do so. However, voters in other eurozone countries, who now know they may have to pay up but have no immediate control over the ex ante government spending habits of bailed-out countries, are on their side more likely to demand an end to this moral hazard by restricting the opportunities of their elected officials to agree to bailouts.

Having seen how the supranational Lisbon Treaty and SGP failed, in the future European voters may instead enforce such restrictions retroactively and at the national level. This is what happened when the newly elected Slovakian parliament

15. The early July 2010 Financial Times/Harris poll showed how two-thirds of voters in Germany, France, Italy, Spain, and the United Kingdom in late June 2010 believed that public spending cuts would "help the economy." See Barber (2010).

16. See Åslund (2010) for a discussion of the Latvian case.

17. Today, Europe's only mainstream center-left party with a patently unsustainable fiscal policy platform is France's Socialist Party under the leadership of Martine Aubry.

18. As discussed in Kirkegaard (2010c), new populist parties have emerged in Northern Europe combining right-wing anti-immigration policies with support for traditional left-wing welfare policies aimed at pampering especially blue-collar workers and (early) retirees. This combination of left- and right-wing policies requires the presence of a politically very skilled and disciplined populist leader to be sustained.

19. Obviously, the rest of the European Union and entire global community also participated in the Greek bailout.

reversed a decision by the previous cabinet to participate in the Greek bailout with a 69-1 vote (14 abstentions) in early August 2010.[20]

Slovakia of course is small (and its domestic banks have next to no exposure to highly indebted countries) and its reluctance to directly financially support much richer Greece is understandable, but the broader risk is that EU leaders lose the political room for maneuver "to do what they have to do" in the next sovereign debt crisis, namely authorize another conditional bailout.

Yet, the political reality facing Europe's elected officials is quite different and they have to deal with the world as it is, not as textbooks or special interests would like it to be.

Partly, this problem is inherent to representative democracy, as elected governments cannot possibly in the midst of a financial crisis "put a bailout before voters" ahead of agreeing to the bailout. Democratic control can instead happen only ex post when voters pass their verdict on their government at the next election.

Credible ex ante constraints must be put on the fiscal policies of all eurozone members to reduce the risk that public opposition in Germany and elsewhere will constrain the options of their elected officials in a future crisis situation to send their taxpayer euros to bail out other eurozone countries (even with IMF conditions attached).

Just as in democracies there can generally be no "taxation without representation" (except here in Washington, DC, of course), in the eurozone there can be no lasting option for "bailouts without credible ex ante fiscal rules." Tough fiscal sanctions are required in a reformed SGP to politically retain the possibility to solve a future crisis through another bailout, i.e., precisely the outcome they nominally are intended to prevent.

Robust fiscal rules for EU and eurozone members in particular thus make up the second required mechanism to limit moral hazard in the European Union going forward. Here the decisions taken at the margins of the Council of the European Union (ECOFIN) meeting on October 19, 2010,[21] and included in the Franco-German Deauville Declaration from Oct 18, 2010,[22] lay down important guidelines for what will ultimately be decided by EU leaders.

The general surveillance of EU members' fiscal policies looks likely to be strengthened as does the ability of EU statistical agencies to verify member states' data. Both are necessary improvements of the current framework. However, it looks clear that the "corrective arm" of the SGP will remain a "political institution" and any financial sanctions against fiscally wayward members will remain subject to a qualified-majority vote among EU/eurozone members.[23] As such, the SGP sanctions will not be automatic and look highly unlikely to ever be implemented (at least against a large member state). At the time of writing (mid-October 2010) therefore, EU leaders look unlikely to agree to the required strengthening of fiscal rules, in order to be able to seriously contain moral hazard in the European Union in the future. This disappointing situation demands that stronger measures to contain moral hazard must be taken elsewhere.

Traditional tools of European policymaking, such as institutionalization in the European Commission, peer pressure among member states, and the SGP itself will correspondingly not play any prominent role in containing moral hazard in the eurozone under the new bailout precedent. This marks a noteworthy shift from previous crises in Europe, where new institutions were typically relied upon to provide the crisis solution.

IV. THE POLITICAL CONSTRAINTS FACING REFORMERS OF THE EU FISCAL POLICY FRAMEWORK

When analyzing the options available for European leaders undertaking longer-term reform of EU institutions (i.e., when they are not in the short term trying to stop an accelerating market panic at 2 a.m. on a Sunday morning before the Asian markets open), it is important to realize the tight political checks they operate under. In many ways, Europe's leaders are far more politically constrained than many critics acknowledge.

This is particularly true of most macroeconomists, who frequently predict the failure of the European Monetary Union, simply because its central institutions do not fully fit the normative descriptions of their presently dominant paradigmatic theoretical models, as expressed in Mundell's (1961)

20. See Tomek (2010). Ultimately, as the missing Slovakian share of the Greek program is very small, it has been made up for by other euro-zone members. But needless to say, if hypothetically in the future Ireland—a country substantially richer in GDP per capita terms than the EU average—were to seek assistance, this political interstate distributional issue would become acute.

21. See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117209.pdf.

22. See http://www.elysee.fr/president/root/bank_objects/Franco-german_declaration.pdf.

23. See Kirkegaard (2010d) for details.

"Optimal Currency Area" theory's demand for a "central transfer mechanism."[24]

It is similarly true of many Brussels insiders, who often seems to espouse the nakedly self-promoting view that whichever new problem Europe is faced with, a new EU institution must be created to address this concern, while EU public opinion will automatically be supportive hereof.

Yet, the political reality facing Europe's elected officials is quite different and they have to deal with the world as it is, not as textbooks or special interests would like it to be. It is crucial therefore to note the two overarching political constraints that today will inevitably shape the coming reform process of Europe's fiscal framework.

The Referendum Reality

Unlike previous generations of EU leaders, say a Kohl, Mitterrand, or Delors—whose "European visions" were often based on their initial ability to ignore the opinions of their voters,[25] EU leaders today face the political reality of having to win popular referenda in multiple member states, if they want to dramatically reform EU institutions and the existing Lisbon Treaty.

While legally minor changes to the Lisbon Treaty will remain feasible without likely triggering political or automatic constitutional requirements for referenda in individual member states (if the proposed changes are small and do not involve the transfer of any national sovereignty to the supranational EU level), far-reaching reforms of the Lisbon Treaty are simply not politically feasible in today's Europe. As proven by the decade-long process required to ratify the Lisbon Treaty, this is certainly true of any treaty reforms that involve additional economic integration at the supranational level.

Moreover, as this is the political reality for members of the eurozone, such as Ireland, the prospects of rapid additional integration within the eurozone only under the Lisbon Treaty's "enhanced cooperation" mechanism looks equally dim.[26] Constraint by this inability to dramatically change the Lisbon Treaty without triggering popular referenda means that any reforms must be relatively *de minimis* in scope.

This constraint clearly suggests that the Franco-German proposal from Deauville about changing the EU Treaty to allow for, among other things, the suspension of voting rights in the EU Council for members in breach of the SGP, will not be feasible in the foreseeable future and definitely not by the 2013 time schedule intended by German and French leaders.[27] Considering the large share of legislation passed today by national EU parliaments that has its origin in EU-level regulation and negotiations, suspending a member state's voting rights in the EU Council would be an extremely undemocratic act, likely to spur very substantial anti-European feelings in the member state thus targeted. Even traditionally pro-European Union national political elites in a member state sanctioned in this way could be expected to feel increasingly disenchanted with the European Union and "the Idea of Europe." Correspondingly, this proposal is both undemocratic and dangerous. Fortunately, it looks extremely unlikely to be supported by member states and even less so by their electorates in what will be required referenda in several member states to ratify such Treaty changes. Suspension of voting rights in the European Union due to excessive deficits will never occur and this proposal is therefore mostly a distraction.

The Lack of a Pan-European Public Identity

Despite the fact that the European Union is easily the most deeply institutionalized regional grouping in the world today and operates through a pooling of member states' national sovereignty that is probably unthinkable elsewhere in the world, it nonetheless exists without anchoring in a genuine popular identity. The European Union and its institutions have been created overwhelmingly as a top-down project by European policy elites composed of elected officials and government bureaucrats, acting as representatives of their respective national populations.

Rule-making and regulation at the European level have historically proven acceptable to EU publics, as they have persistently reelected their generally pro-European leaders responsible for transferring national sovereignty to Brussels (this is true, even if they reject the same politicians' appeals in occasional referenda about specific EU-related topics). At the same time, however, it is important to realize that even today Brussels' competences very deliberately do not cover the

24. See for instance Feldstein (2010) and Krugman (2010) for this type of euro-critiques.

25. Francois Mitterrand did on September 20, 1992, consult French voters regarding the Maastricht Treaty. The question was asked "Do you approve the draft law put to the French people by the President of the Republic authorizing the ratification of the Treaty on European Union?" On a turnout of 69.8 percent, 51 percent voted "yes," while 49 percent voted "no." See Criddle (1993).

26. "Enhanced cooperation" under the Lisbon Treaty requires that at least nine EU member states participate from the beginning, that it is open to new members, and that the policies are accepted by a qualified majority in the EU Council (unanimity is required in foreign and defense issues) and a majority in the European Parliament. As such, if a qualified minority of EU member states wishes to block others from proceeding, they can do so.

27. See http://www.elysee.fr/president/root/bank_objects/Franco-german_declaration.pdf.

public policy subject areas most important to the everyday lives of individual voters, including social policy, labor markets, health care, and taxation.[28]

Large majorities of self-identified EU member state nationals will simply not accept large and regularized transfers of national tax revenues to Brussels or other member states.

Indeed, when looking at the extremely complicated EU decision-making apparatus, complete with exclusive "community powers" in some subject areas (or pillars), concurrent or exclusive member state jurisdiction in others, as well as the extensive institutional checks-and-balances between the European Commission, the EU Council (i.e., member states' governments) and the European Parliament, it quickly becomes clear that EU institutions originate in a host of very finely balanced political compromises. And that these compromises between "integrationist and nationalist political forces" in turn are shaped by a fairly astute political understanding of just how much EU integration is ultimately acceptable to EU publics.[29]

Radical changes of existing EU institutions, even following unprecedented economic events such as the Greek sovereign debt crisis, are consequently unlikely. Any change will be incremental and large leaps of new integration and institution-building are not feasible, as the EU population continues to lack a pan-European identity and instead overwhelmingly retain their identities at the national level. This is illustrated in figure 2 with the most recent polling data from the European Commission.[30]

Figure 2 shows how 90 percent of EU-27 residents on average self-identify as either "only nationals" of their home country or as "first nationals, then Europeans," and that only in Luxembourg (a small country with numerous EU institutions) does this percentage drop below 80 percent. In other words, an overwhelming majority of voters in all EU member states self-identify as principally nationals of their home country, a polling result that has been quite stable for decades.[31]

This matters tremendously when considering the opportunities for EU leaders to launch a greatly expanded central EU budget or even a common EU fiscal policy with regular large-scale transfers across borders. It is not a coincidence that the current EU budget is capped at 1.24 percent of EU GNP, i.e., numerically quite similar to the share of Europeans who declare themselves "only European." Large majorities of self-identified EU member state nationals will simply not accept large and regularized transfers of national tax revenues to Brussels or other member states.

The general willingness of Europeans to accept high levels of taxation, a feature closely related to the historically relatively high degree of homogeneity inside European nation states (all welfare states stop at the national border!), does manifestly not extend to paying taxes to the European Union in Brussels. In many ways this resistance against paying taxes at the "continental level" among Europeans is conceptually similar to the generally higher unwillingness of Americans to pay "taxes to their continental capital" in Washington, DC.

Moreover, it would be a mistake to believe that, for instance, US fiscal history suggests that the emergence of the gradually more powerful centralized government (e.g., the US federal government) led to any immediate increase in its fiscal weight. This is illustrated in figure 3.

Figure 3 plots total US federal government expenditures from 1792 to 2009, as well as total federal expenditures excluding federal spending related to US engagement in war fighting.[32] It can be seen in figure 3 that only by the onset

28. In addition the "subsidiarity principle" enshrined in the Lisbon Treaty's Article 5 is intended to ensure that legal decisions are taken as closely as possible to the citizen, and that repeated actions are taken to ascertain whether action at the EU level is justified when considering the possibilities available at national, regional, or local levels.

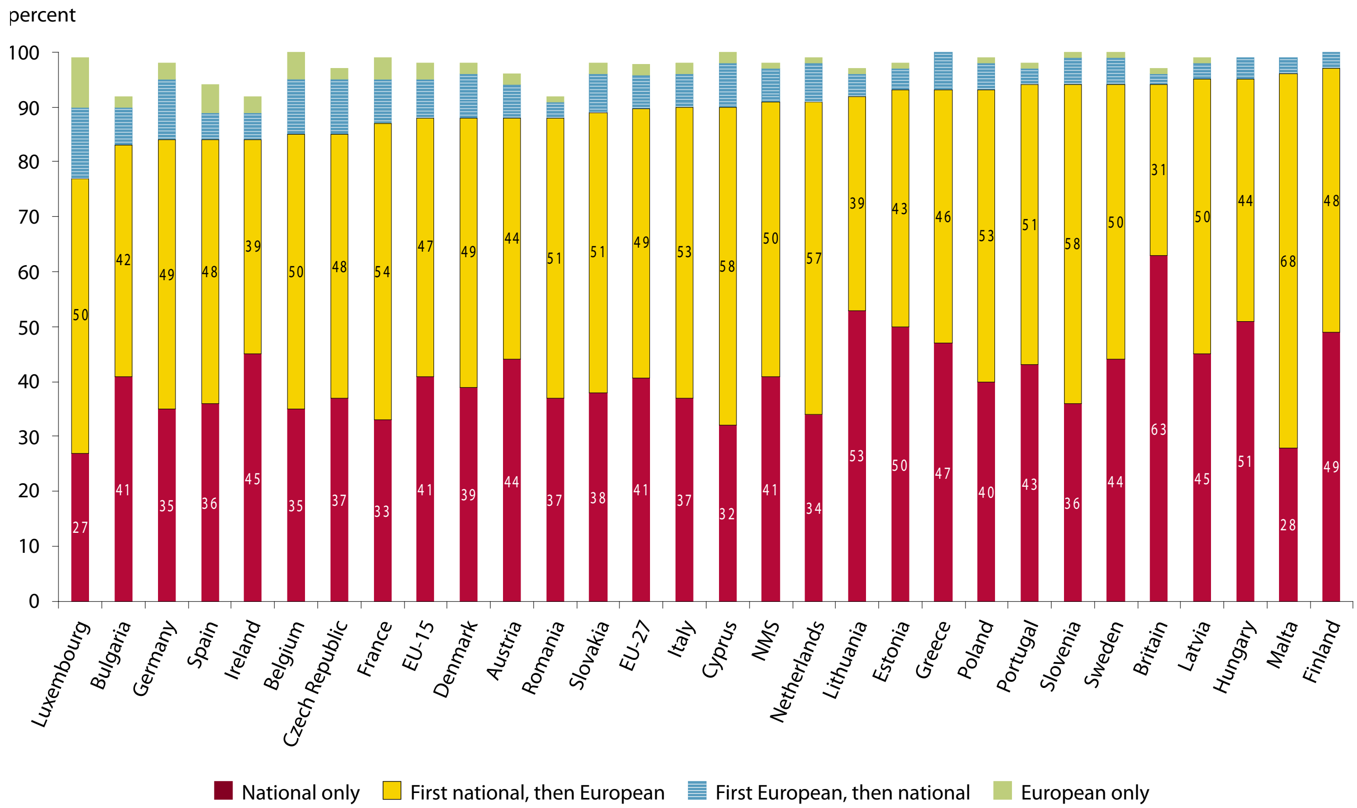
29. Similarly, it is clear from analyzing the very finely balanced internal EU decision-making procedures painstakingly established over decades, just how difficult it will be for the European Union under the new Lisbon Treaty to put together a coherent and unified external EU representation while simultaneously maintaining national member state foreign policies and representations. How the balance between European Union and member states external representation will work in practice will likely, as with internal EU decision-making processes, take decades to establish in practice.

30. Numerous different polls exist concerning the "identity of Europeans." However, relying on the polling data from the European Commission's Eurobarometer has several advantages. First of all, it ensures that polling data results are collected using similar methodologies across all member states. Secondly, the same polling question has been asked several times, so a "time series" of data results is available. And thirdly, with the Eurobarometer being part of a decade-long project sponsored by the European Commission, there is a very limited risk of "funding bias" in individual poll results.

31. Results in figure 2 rely on data from Eurobarometer 64.2 (European Commission 2005). The same question was asked in the earlier Eurobarometer 62 (European Commission 2004) with essentially the same result. See an overview of earlier Eurobarometer questions concerning European identity at http://www.gesis.org/dienstleistungen/daten/umfragedaten/eurobarometer-data-service/eb-trends-trend-files/list-of-trends/europ-identity/?tx_eurobaromater_pi1[vol]=Cultural percent20identity,National percent20/ percent20European percent20identity,1395&tx_eurobaromater_pi1[pos1]=335&tx_eurobaromater_pi1[pos2]=16.

32. Figure 3 data for total federal spending, excluding War Department and

Figure 2 Europeans' self-identification, mid-2000s[1]



1. Answer to question "In the near future, do you see yourself as….?". "Don't know" answers excluded.

Source: Eurobarometer 64.2.

of America's participation in World War I in 1917—134 years after the end of the American Revolutionary War in 1783—had the US federal budget, excluding expenditures to war fighting, grown to a size significantly beyond the scope of today's EU budget of about 1.17 percent of EU GDP.[33] And only following the New Deal in the 1930s and World War II did the US federal government permanently grow to a scale far beyond the EU budget.

With a just over 50-year history and fortunately no chance of ever being in charge of a war, the EU budget—superficially compared to US fiscal history—should therefore remain at today's level for decades to come.

In summary, rapid institutional shifts toward a European "Fiscal/Transfer Union" with a large centralized Brussels-based budget are simply not politically feasible in Europe without a common identity and where referenda are required for the foreseeable future.

V. WHY GERMANY HAS GAINED SO MUCH POLITICALLY FROM THE GREEK SOVEREIGN DEBT CRISIS

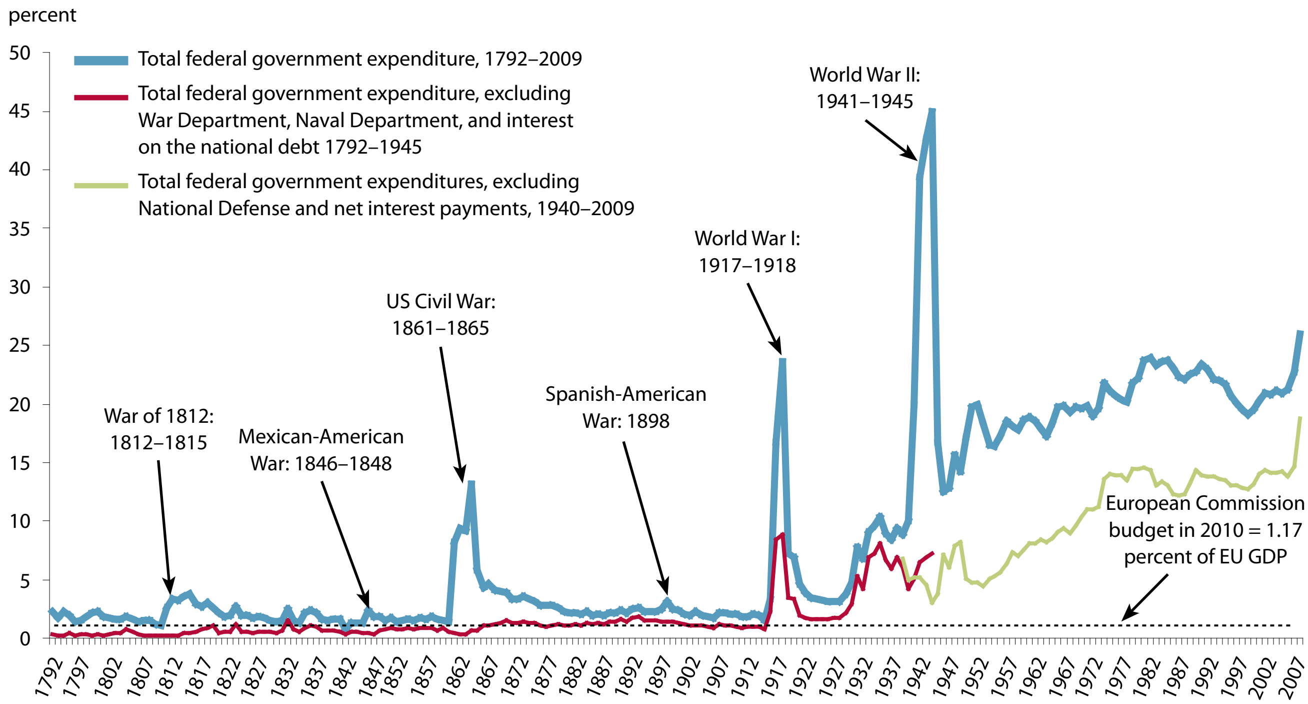
"Normal countries," even if they are members of the European Union and pool large parts of their sovereignty, tend nonetheless to want to maximize their national influence over their neighbors and their geographic region. With Germany today finally a wholly "normal country," no longer excessively constrained by its past in its peaceful pursuit of its national interest, this logic now applies in Berlin, too. And as the eurozone's new revealed safe haven country, maximizing Germany's national interest within the EU will become a lot easier postcrisis.

German bond yields now decline in times of crisis, while the yields of peripherals rise, which will make any German demands for more fiscal discipline weightier. Thanks to its

Navy Department up until 1915 excludes civil expenditures in the War and Navy Departments.

33. Note that the EU budget is estimated as roughly 1.24 percent of EU GNI, which is slightly lower than EU GDP.

Figure 3 US Federal government expenditures 1792–2009, percent GDP



Source: MeasuringWorth.com; Expenditure data from 1972–1945 from US Census (1949); data from 1945–2009 OMB (2010). Note annual data from differing fiscal year periods.

stronger fiscal outlook and external surpluses, Germany—in any serious future economic policy clash with its EU partners—can now afford simply to say "nein," sit back, watch spreads widen, and let its new ally in the global bond markets convince its EU partners of the need for fiscal discipline and economic reform.

It would be foolish to underestimate how such "economic crisis power" translates into continuously enhanced political power, as the other EU countries realize the true costs of escalating future conflicts with Germany. Certainly, defying German wishes with a veto on large economic questions, where EU unity is seen as pivotal and perceptions of discord will raise uncertainty in the financial markets, will be close to impossible for a high-debt peripheral eurozone member in the future. Berlin will increasingly get things its way in the European Union.

Or put another way, nothing will do more to diminish French influence in the European Union than Germany's new economic safe haven status, combined with France's own increasingly shaky government finances. Indeed superior German fiscal fundamentals may easily neutralize the advantage of France's growing population (compared to Germany's forecast decline) in the EU Council's double-majority rules, where both voting and population majorities are required for decisions to be taken.[34]

Continued equal standing in the Franco-German axis at the heart of the European Union could correspondingly soon require policy reforms like, say, a higher French retirement age, a more liberalized French labor market, or similar structural reforms and related austerity measures.

One immediate example of Germany's postcrisis agenda-setting power in the EU is the lack of serious demands from euro-zone external deficit countries of the consequences for them of the persistent German intra-eurozone current account surpluses. But, as the saying goes, you don't bite the hand that feeds you in a crisis.

At the same time of course this rise in the German government's economic and political power has exacted a cost on Germans and remains conditional. First of all, Germany has in the last decade undergone a tough economic transition

34. The EU Treaty lays down the member states' voting weights and the requirements for simple majority, qualified majority, or unanimity. In addition, a member state may ask for confirmation that the votes in favor of a proposal represent at least 62 percent of the total population of the European Union. If this is found not to be the case, the decision will not be adopted. See http://www.consilium.europa.eu/showPage.aspx?id=242&lang=EN.

characterized by intensive offshoring by and reorganization of the German corporate sector, accompanied by substantial structural reforms of pensions and (insufficiently still) labor markets to overcome the fiscal excesses of German reunification and euro adoption. Indeed, it is easy to see a split between German politicians eager to pursue policies that will maximize their influence in the European Union and their voters, dissatisfied with having to bear the costs of these policies.

Secondly, Germany has set itself a tough fiscal benchmark in the form of its constitutional "structural balanced budget" amendment to take effect at the federal level in 2016.[35]

And thirdly Germany has, as discussed above, agreed at least initially until 2013 to provide the unprecedented anchor financing for the occasional future conditional bailout of weaker eurozone countries through the EFSF. Germany will retain its crisis safe-haven status and increased political influence only if it can continue to "lead by example" on the two former issues, domestic structural reform and fiscal sustainability, while continuing to politically accept the latter. Therefore also out of a desire to entrench its safe-haven status and elevated political influence, Germany can be expected to continue its austerity measures, despite higher than expected economic growth and tax revenue figures for 2010.

Note that through the EFSF Germany has in reality, despite opposing it in general, accepted to participate in a facto "crisis-only Eurobond." The EFSF therefore in many ways represents the biggest politically possible step forward for a "common European fiscal policy," precisely because it does <u>not</u> entail the creation of new permanent common fiscal policy institutions. Such a European fiscal policy is not and will likely never be politically feasible (see section IV) in the form of stable, frequent, large fiscal transfers between member states (e.g., like the US federal government budget transfers revenue between US states). However, the EFSF illustrates that ad hoc potential fiscal transfers between member states are politically possible in times of acute economic crisis in order to avoid the economic collapse of individual member states and associated spillover risks for the entire European Union. Or at least small member states, as the EFSF may not be big enough to shore up a large member state in acute crisis.[36]

While the EFSF is therefore no substitute for a permanent "European fiscal policy" in normal times and hence won't be of any help in preventing asymmetric shocks, it will be available when such asymmetric shocks and a corresponding acute crisis make its operation politically feasible. As such, the EFSF in some ways mimics Alan Greenspan's approach to economic bubbles—don't do anything to try to avoid them, but merely try to help clean up the mess afterwards. Not perhaps optimal in terms of avoiding economic instability in the eurozone (asymmetric shocks will still happen without an immediate central fiscal response), but the maximum politically feasible and a potent institution in fighting the effects of a eurozone crisis once it has arrived.

The battle about under what circumstances the EFSF can be made permanent will therefore be crucial for the long-term outlook for the stability of the eurozone.

VI. THE ROAD PAST BERLIN AND BRUSSELS GOES THROUGH AN E-SDRM AND FINANCIAL MARKETS

Eurozone governments will be increasingly aware of the enhanced German political influence resulting from diversified sovereign risk premiums and credit ratings. Or put in another way: For eurozone peripherals, as well as core countries like France, lack of sustainable government fiscal policies from now on means less political influence and ultimately fiscal sovereignty ceded to Germany.

So for EU governments contemplating how to reduce moral hazard in a Europe where bailouts are feasible and what kind of SGP reform to accept, the real question is in some ways where they would rather in a future crisis risk ceding fiscal sovereignty to—Brussels, Berlin, or somewhere else?

In answering this question, what are the principal issues EU and German leaders must take into consideration?

First, EU leaders must respect the hard political constraints outlined in section IV that exist in today's Europe, and therefore ignore the advice given to them by most macroeconomists and euro-federalists for much more EU integration and entirely new institutions, such as a fiscal union. Furthermore, any reforms must be implemented without having to change the Lisbon Treaty in order to be timely. Implementing a Treaty change in order to potentially strip members in excessive deficits of the voting rights in the EU Council, as suggested in

35. "Structurally balanced budgets" mean that a German government would be able to spend countercyclically and run deficits to protect the national economy against severe economic downturns, as for instance witnessed in 2009. German states will have to adhere to the same structural deficit ceiling from 2020.

36. Put in another way, despite the measures taken by the European Union since early May 2010, it remains uncertain that the European Union will be financially able to bail out a large member state like Italy or Spain, were these two members to find themselves in a "Greece-like situation" in the future. This is unlike the situation in the United States, where there can be little doubt that the federal government would—if it politically decided to do so—be capable of bailing out even the largest US state of California. In Europe, therefore, it remains the case for large members that the only guaranteed rescue they can hope for is by "bailing themselves out," i.e., putting in place the necessary domestic reforms to secure long-term sustainability (often by "defaulting on promises made to their own populations").

the October 2010 Franco-German Deauville Declaration, is an utterly unrealistic option.

Secondly, EU leaders must be mindful that future German governments intent on and capable of structurally balancing their budgets make the immediate requirement for a tough new SGP or other measures against moral hazard less urgent for Berlin. Germany can afford to reject a "weak SGP" or other inefficient measures to check moral hazard that it does not like, knowing that it has powerful allies in the financial markets that will look unkindly on a failure of EU leaders to agree to limit moral hazard. Increased "uncertainty about the future of Europe" from a failure to put teeth into the SGP or implement other ways to limit moral hazard will cause peripherals' bonds to decline and Germany's to rise, so ultimately in the absence hereof, markets will do much of Germany's dirty work for it by keeping free-spending EU countries on the fiscal path of virtue. This is particularly important to recall when thinking about how to potentially make the EFSF permanent, in so that were the EFSF to be allowed to expire in 2013, this would be potentially very costly for the weaker eurozone peripherals. Without the crisis-only rescue financing available from the EFSF, they will rightly be perceived by financial markets as more risky and face higher costs of refinancing and will therefore be the big losers if the EFSF disappears.

So for EU governments contemplating how to reduce moral hazard in a Europe where bailouts are feasible and what kind of SGP reform to accept, the real question is where they would rather in a future crisis risk ceding fiscal sovereignty to—Brussels or Berlin?

Thirdly, EU leaders must bring back the focus on debt stock levels in the eurozone to promote genuine longer-term fiscal sustainability, i.e., begin referring also to the 60 percent Total Government Debt Criteria in SGP enforcement.[37] An immediate and rigid enforcement of the 60 percent general government debt ceiling is obviously not feasible today, as only a few eurozone members would qualify. Instead, more flexible ways must be found that do not require a change in the Lisbon Treaty.

Leaders could, for instance, broaden the current definition of general government debt included in the debt stock criteria to also include some types of private debt, and then dictate a higher range of permissible total debt stock of 60 to 90(?) percent of GDP, depending also on other relevant issues like the domestic savings rate, future increases in age-related spending, or the extent of other government assets (European Commission 2010a). Based upon such a broader set of parameters, an appropriate speed (numerical target) of debt stock reduction should be identified for countries with more than 60 percent of GDP in general government debt.

Fourthly, EU and especially German leaders should reject a "eurozone exit clause" Eurozone exit must not be facilitated, as it is precisely the prohibitively high costs for weaker members of leaving the eurozone and the common currency[38] that in the end provide the coercive basis for structural reform progress in these countries. Only when faced with the economic and political disaster of a forced eurozone departure do weaker countries contemplate swallowing their bitter economic medicine.[39] Making it easier for such countries to escape tough structural reforms through a return to competitive devaluations is simply not in the European Union or Germany's interest.[40] Moreover, introducing a formal eurozone exit clause would require a change of the Lisbon Treaty.

Instead and fifthly, German and other EU leaders should adopt a less far-reaching "eurozone orderly sovereign debt restructuring mechanism" (E-SDRM) without an exit clause. This will protect eurozone (especially German and French) taxpayers by ensuring creditors share the cost of any sovereign restructuring of weaker member states' debts. Conceptually, such a mechanism would be close to the sovereign debt restructuring mechanism (SDRM) proposed by IMF (2002) staff and could be implemented as a nominally "politically voluntary" agreement among eurozone members through the addition of the relevant legal clauses to national sovereign bonds.[41] A change in the Lisbon Treaty would not be absolutely required.

37. Often referred to as the "original sin" of the SGP, the 60 percent debt ceiling was politically sacrificed in 1997 to enable high-debt Italy and Belgium to become founding members of the euro. Ignoring the stock of debt, the SGP was instead focused only on adhering to the 3 percent annual budget deficit limit from the beginning.

38. See Blejer and Levy-Yeyati (2010) for a recent exhaustive analysis of such costs.

39. Or put in another way: Countries that enter the postcrisis eurozone prematurely in the future (like Greece did in 2001) will do so with a near certainty of falling increasingly under the sway of Germany.

40. The suggestions made by German Finance Minister Wolfgang Schäuble in the *Financial Times* on March 12, 2010 are therefore against Germany's national interest. See Schäuble (2010).

41. Mexico and several other countries in the early 2000s voluntarily issued national bonds with collective action clauses (CACs) enabling simple majorities of debtors to amend the financial terms of the debt (and thereby force the hand of the minority) in ways corresponding to intent of the SDRM proposal.

In many regards, an E-SDRM would follow in the steps on the coming ECB risk control measures in its collateral program. Depending on their rating, coupon, and maturity, from January 1, 2011, the sovereign debt of a country like Greece will be subject to up to a 13.5 percent haircut when used as collateral in the Eurosystem's open market operations.[42] As such, similarly to the precedent for eurozone bailouts after Greece, the eurozone will have a precedent for demanding diversified creditor haircuts on weak members' sovereign debt from January 1, 2011.

Given the likely failure of EU leaders to sufficiently shore up the corrective arm of the SGP, so that credible financial sanctions would limit moral hazard in the European Union, the implementation of an E-SDRM has become more urgent. Unlike both the conditions attached to bailouts and a tougher SGP, which targets EU governments, an EDRM would have private financial markets, e.g., bond investors, as its focus. By "bailing in" private creditors through required haircuts, an EDRM would—by transferring some of the costs of future bailouts from taxpayers to private creditors—be certain to solidify the political commitment to provide public money, too, to any future bailouts.

Moreover, by establishing an E-SDRM, EU leaders would have the advantage of not having to push more unforeseen losses onto a shaky banking system and jittery financial markets in the middle of the next sovereign debt crisis. An E-SDRM would have the large signaling benefit to ex ante make it clear to investors that weaker eurozone members' debt is in fact not risk free, despite the implicit political guarantee from the Greek precedent for bailouts.

Hence an E-SDRM will have the effect of further increasing intra-Eurobond spreads, as weaker members' bonds would now be viewed as relatively more risky than safe-haven Germany. Higher spreads would obviously further entrench German economic power in the European Union, but at the same time provide an additional and beneficial constant "nudge" toward both structural reforms and sustainable fiscal policies for weaker euro members. In some regards, an E-SDRM would therefore directly substitute for a radical political strengthening of the SGP.

Given the lasting political benefits to Germany from an E-SDRM, it seems likely that it can only be agreed at the EU level at times when German postcrisis political leverage is at its maximum. This may not be in relation to the EU Council negotiations among 27 member states aimed at reforming the SGP framework by December 2010. Instead, Germany's ability to extract a "quid pro quo" will be at its highest at times when "money is needed right away."

As such, the introduction of an E-SDRM looks perhaps more likely to happen as a "quid pro quo" separate from the SGP negotiations for either German acceptance of an extension of the current EU/IMF program for Greece. Such an extension looks likely to be required prior to 2012, when Greece is supposed to return to the long-term debt markets.

Or more likely, German acceptance of making the temporary three-year EFSF permanent after it expires in May 2013—just a few months before the next German Bundestag elections in the fall of 2013. In many ways, while the Deauville Declaration undercut the potency of the SGP (and new Brussels powers to police members' fiscal policy), it fortunately simultaneously strengthened the likelihood that an E-SDRM will be implemented. This is clear from the key section of the declaration, which reads with respect to making the EFSF permanent:

The establishment of a permanent and robust framework to ensure orderly crisis management in the future, providing the necessary arrangements for an adequate participation of private creditors and allowing member states to take appropriate coordinated measures to safeguard financial stability of the euro area as a whole.[43]

Perhaps in return for the "undermining of the SGP," the French government expresses its support for "private sector participation" (e.g., an E-SDRM-like framework) in future European bailouts. This is crucial, as historically few major changes in EU policy have occurred without the prior agreement of France and Germany. Moreover, it should be recalled that—if France succeeds in making its fiscal outlook sustainable and hence secures its strong AAA rating—an E-SDRM framework will not be particularly costly for France. With its fiscal house in order, French bonds can be expected to closely track those of Germany even after an E-SDRM is implemented. Instead, the costs will be borne mainly by weaker peripheral members.

Europe in summary looks set to implement two out of three required measures against moral hazard in the future. Conditionality on all bailouts, as well as requiring haircuts for private creditors will eventually be in place, while the SGP will remain a largely toothless institution. Certainly, two out of three is not an ideal longer-term policy response from Europe

See IMF (2003). As pointed out in von Hagen (2010), this would create a dual market for countries' bonds for a transition period: some with and some without covenants regarding mandatory haircuts in a restructuring. This issue, however, would be temporary.

42. See ECB July 28, 2010, press release at http://www.ecb.int/press/pr/date/2010/html/pr100728_1.en.html and annex of mandatory haircuts at http://www.ecb.int/press/pr/date/2010/html/sp090728_1annex.en.pdf?60ff4ae0a22dc83d8398a5f33e03e725.

43. See http://www.elysee.fr/president/root/bank_objects/Franco-german_declaration.pdf.

against the moral hazard arising in the European Union as a result of this crisis, but it is not bad either. With an E-SDRM eventually in place, Europe will not have "wasted this crisis."

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