



The Coming Resolution of the European Crisis: An Update

C. Fred Bergsten and Jacob Funk Kirkegaard

C. Fred Bergsten has been director of the Peterson Institute for International Economics since its creation in 1981. He is a member of the President's Advisory Committee on Trade Policy and Negotiations and the Advisory Committee to the Export-Import Bank, and co-chairman of the Private Sector Advisory Group to the United States–India Trade Policy Forum. He was assistant secretary for international affairs of the US Treasury during 1977–81; undersecretary for monetary affairs during 1980–81; and assistant for international economic affairs to Dr. Henry Kissinger at the National Security Council during 1969–71. Dr. Bergsten has authored, coauthored, or edited 40 books on international economic issues. **Jacob Funk Kirkegaard** has been a research fellow at the Institute since 2002 and is also a senior associate at the Rhodium Group, a New York-based research firm. Before joining the Institute, he worked with the Danish Ministry of Defense, the United Nations in Iraq, and in the private financial sector. He is author of *The Accelerating Decline in America's High-Skilled Workforce: Implications for Immigration Policy* (2007) and coauthor of *US Pension Reform: Lessons from Other Countries* (2009) and *Transforming the European Economy* (2004).

© Peter G. Peterson Institute for International Economics. All rights reserved.

Everyone must be prepared to overcome their specific weaknesses: the European Union by overcoming the design defects of the Economic and Monetary Union, the United States by reducing its budget deficit, and China and other developing countries must assume their responsibility by allowing more exchange rate flexibility.

—Angela Merkel, statement to the German Bundestag, June 14, 2012¹

1. Translated by the authors from the original German text available at www.bundeskanzlerin.de/Content/DE/Regierungserklaerung/2012/2012-06-14-bkin.html?nn=74514.

A POLITICAL CRISIS DIAGNOSIS

Getting the diagnosis right is a prerequisite for understanding the euro area predicament and evaluating key decisions taken since early 2010. As we laid out in Bergsten and Kirkegaard (2012), while the euro area faces multiple overlapping and mutually reinforcing elements of fiscal (Greece), banking (Ireland/Spain), and competitiveness (Southern periphery) crises, it is first and foremost facing a crisis of institutional design. The common currency as designed in the Maastricht Treaty of 1992 is a half-built house without the critical components of banking and fiscal union necessary to sustain it through the type of crushing economic and financial downturn witnessed since October 2008.

It is no coincidence that the euro design is as flawed as it has proven to be. The founding members of the common currency did not have the political will in the early 1990s to surrender their national control over vital areas of “deep sovereignty” like domestic banking sectors and fiscal policy. At its core the euro area crisis is about national sovereignty and the process in which European governments can agree to transfer it to new, required euro area institutions governing banking sectors and fiscal policies.

Analyzing the crisis through a political economy prism reveals that financial market pressures significantly affect, but not dictate, political decisions about national sovereignty in the euro area. While financial markets play a large—indeed necessary—role in forcing euro area policymakers into taking necessary decisions, they can prescribe neither the substance of these decisions nor their timing. National sovereignty is a commodity that governments anywhere—even in the euro area when it concerns deep sovereignty issues—would never dispense with in normal times. It is handed over or pooled only when the immediate alternative is much worse.

Historically, nations have surrendered sovereignty when faced with an imminent threat of armed force, which in the case of Europe fortunately is no longer relevant. Nonetheless, what euro area policymakers face today—the imminent collapse of the European financial system and indeed the common currency itself—approaches threat levels similar to direct military action and is enough to prompt them to

transfer deep national sovereignty to new institutions. Because deep national sovereignty is relinquished only during an extraordinary crisis, the euro area policy response can only be reactive. Decisive proactive measures to end the crisis in one fell swoop are simply politically impossible. The ongoing crisis can greatly accelerate the decades-old political project of European integration but cannot suddenly complete it.

We put forward a third theory to describe the current process of European integration: the “only on the brink” theory.

There have been two schools of thought on how European integration would be achieved²: the locomotive theory, where the common currency would be introduced early and act as a locomotive for additional economic and political integration of Europe³; and the coronation theory, where a common currency would be introduced only at the end of a long process of real economic and political integration in Europe. As described in Bergsten and Kirkegaard (2012), the locomotive theory won out, as Europe needed a swift strategic response to German unification in 1990 and thus settled on the quick and dirty politically achievable solution of a monetary-only Economic and Monetary Union (EMU).

However, history since the introduction of the euro in 1999 shows the locomotive theory is empirically wrong. The introduction of the common currency itself did not facilitate any increase in economic and political integration in the euro area. It produced the opposite result. Indeed, as described in Duval and Elmeskov (2005, 35), “there appears to have been a slowdown in the reform process in EMU countries after the formal advent of the euro.” Private financial markets mistakenly responded by prolonged underpricing of sovereign risk following the introduction of the euro, allowing all sovereign borrowers to borrow at ultra-low German interest levels until the global financial crisis hit in 2008. Euro area governments, in turn, continued their policy failures by maintaining unre-

formed national economies and a common currency with a faulty design.

We put forward a third theory to describe the current process of European integration: the “only on the brink” theory. It is inspired by our colleague John Williamson’s definitive description of the political economy of policy reform in emerging markets (Williamson 1994) and how periods of crisis-related “extraordinary politics” are often necessary for implementing far-reaching structural reforms. The failed attempt to introduce a European Constitutional Treaty in 2005 shows that further European integration and institutional reform is not democratically possible in periods of normal European politics. A crisis and imminent economic catastrophe are almost certainly required to overcome daunting political obstacles.

Our political-economy inspired euro area crisis diagnosis that the euro area needs to pool substantially more national sovereignty with new euro area institutions has significant implications for the theoretical tools used to analyze the crisis. If, for instance, one thought that the crisis is predominantly a fiscal crisis, the analytical focus would be on debt sustainability.⁴ If it is mostly a banking crisis, attention would be on the size and solvency of countries’ financial sectors.⁵ If the main concern is competitiveness, the spotlight would be on countries’ unit labor costs and the euro area’s optimal currency area characteristics. All these tools are useful for looking at elements of the problem, but using them as a guide to describe the euro area’s actual political crisis is, however, misguided and leads to erroneous predictions about key policymakers’ actions.

The distributed sovereignty within the euro area—which lacks a single, undisputed center of power with full control over all policy areas—is the key determinant of the European policy response. With national governments, rather than pan-European institutions, still controlling key crisis policy areas of banking regulation and fiscal policy, political moral hazard is and will remain the overarching political concern shaping the intergovernmental crisis response. Some governments (e.g., Germany) fear that the political and economic incentives provided by bailouts will make recipient (peripheral) governments complacent about fully implementing reforms and austerity measures.

It is, therefore, impossible to deploy overwhelming financial force to quickly restore confidence among private market participants. Overwhelming financial force cannot be marshaled unless the mobilizing entity has the political power

2. The “locomotive theory” was generally favored by France, Belgium, and Luxembourg among the founding six members of the European Union, as it entailed initial continued national control of large parts of the economy while sharing monetary policy (and thus ending German monetary dominance). The “coronation theory” was supported by Germany, Netherlands, and partly Italy, as these countries preferred the establishment of full common control over the economy before sharing monetary policy. See Kruse (1980) and Wolf (2002) for a detailed theoretical description of the two schools of thought.

3. The “locomotive theory,” which at its core is a “neofunctionalist spillover theory” of integration, is very similar to C. Fred Bergsten’s “bicycle theory” of international trade and economic integration.

4. See IMF, “Staff Guidance Note on Debt Sustainability Analysis for Market Access Countries,” July 3, 2008, www.imf.org/external/np/pp/eng/2008/070308a.pdf.

5. See, for instance, the latest IMF Global Financial Stability Report at www.imf.org/external/pubs/ft/gfsr/2012/01/index.htm.

to fully dictate the responses of the recipient entities. This logic underpins the standard International Monetary Fund (IMF) approach of lending only to crisis countries whose governments credibly commit to implementing far-reaching political and economic reform in return for emergency financial assistance. The lack of such power is why euro area firewalls and bailout funds have been insufficient to quell market uncertainties about the future of the euro area. Had they been successful, it would have eroded the incentives of, for instance, the Italian parliament to pass critically needed but politically very difficult domestic economic reforms.

While we are absolutely certain that if called upon in an emergency, the key European players (e.g., Germany and the European Central Bank [ECB]) would pay whatever it takes to rescue the euro, it must be clear that the euro area will not assemble overwhelming financial force or a sufficiently high firewall *in advance*. This is so for reasons of democratic accountability, as the providers of financial assistance (Northern taxpayers) do not have direct influence over the actions of recipient governments elected by taxpayers in those euro area countries. Were the euro area to actually assemble “a bazooka” sufficiently large to, say, bail out both Spain and Italy simultaneously, its existence would make Spanish and Italian policymakers complacent in their domestic economic reform efforts, ultimately making such a large bazooka more likely to be used.

Two key political parameters—one temporary and the other permanent—dictate the size of any bailout, the height of any euro area firewall, or the degree to which member states’ debt or potential future contingent liabilities can be pooled among euro area member states.

The temporary political parameter follows straight from the IMF’s approach and is the degree of conditionality attached to a bailout program in the euro area. This issue has been settled through the troika (e.g., joint reform program management of the IMF, the ECB, and the European Commission), which is in charge of bailout disbursement and reform program implementation for Greece, Ireland, and Portugal. These three euro area members have had to temporarily subject themselves to standard IMF program conditionality with the associated loss of national sovereignty over most government economic policy decisions.

The permanent political parameter is the degree to which euro area member states agree to surrender their national sovereignty on fiscal and other relevant matters (for instance, banking supervision) to new euro area governance institutions. Only new euro area institutions with the political authority to compel national government actions on deep sovereignty issues in fiscal and other areas can alleviate the democratic deficit asso-

ciated with permanent debt and contingent liability mutualization. Political and financial integration of the euro area will have to follow each other in a synchronized and proportional process to be legitimate and thus feasibly agreed among 17 different countries.

Many observers view this link between political and economic/financial integration as a recipe for gridlock in Europe. This mistaken view is rooted in the misperception that economic and financial integration in Europe must be completed right away or eurobonds (including immediate conversion of large amounts of existing national sovereign debt into new joint liability debt) must be introduced immediately. Since mainstream commentary easily establishes that setting up proportional political institutions in the euro area—e.g., a euro area federal finance ministry—is simply politically impossible in the short term, as it would require fundamentally revising the EU Treaty, looming failure is the inevitable verdict for the common currency.

A related widespread misperception centers on the apparent sequencing problem in the euro area, where on the one hand Germany demands political union and on the other France demands the introduction of eurobonds, and neither is willing to first accede to the demands of the other. In reality, and despite the clamor of many self-interested market participants, there is no urgent need for full conversion of all existing euro area national sovereign debt into eurobonds and thus for an immediate political shift toward full fiscal federalism. There is plenty of political space and time to secure a gradualist proportional compromise between the German and French positions. Such a compromise will gradually introduce joint liability debt instruments and joint contingent liability guarantees in the euro area, synchronized closely with the gradual and proportional transfer of relevant national sovereignty to the euro area.

Such a compromise can be achieved in many ways. Starting small, the European Commission proposals for so-called project bonds, the Europe 2020 Project Bond Initiative,⁶ has already been accepted by the EU Council and EU Parliament and will in all probability begin to be implemented by the European Investment Bank (EIB) later in 2012. These project bonds, which will be backed by the entire EU-27 (i.e., not just the euro area), are intended to “fund pre-identified transport, energy and ICT priority infrastructures of EU interest, and

6. European Commission, “Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, and the Committee of the Regions, A pilot for the Europe 2020 Project Bond Initiative,” Brussels, October 19, 2011, http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/documents/com2011_660_en.pdf.

both physical and information technology infrastructures, consistent with sustainable development criteria⁷ but are in the pilot phase not presently intended to exceed more than €400 million to €500 million. Viewed in the context of the euro area's much broader financial problems, these bonds are inconsequential. However, when seen as a step toward more joint liability debt issuance in the euro area, its precedent-setting effect should not be underestimated.

Other potential gradualist proposals include eurobills⁸ (i.e., the issuance of joint liability debt in the euro area for only the short end of the yield curve); the European Debt Redemption Fund⁹ (i.e., pooling all national sovereign debt above 60 percent of GDP into joint liability eurobonds); the Red Bond/Blue Bond proposal¹⁰ (i.e., only the first 60 percent of national debt to GDP would be eurobonds); the European Commission's Stability Bond proposals¹¹; and William Cline's recent proposal to rely on euro area bond insurance.¹²

The common denominator in all these proposals is that they entail a partial mutualization of euro area sovereign debt, which would require transfer of only parts of member states' remaining national sovereignty over fiscal policies to the euro area. Looking at the long history of European integration, it would be a mistake to underestimate the ability of European policymakers to engineer such partial but ongoing transfers of fiscal sovereignty.

As we elaborate below, euro area banking sector integration also needs the same proportional transfer of national sovereignty and joint euro area underwriting of contingent liabilities. Here the shift toward a single euro area deposit insurance scheme and resolution fund (e.g., joint euro area contingent liabilities) will take place only with the simultaneous shift toward a common euro area resolution authority, a single euro area banking supervisor with ultimate decision-making powers, and a uniform single rulebook for pruden-

tial banking supervision (preferably for the entire European Union). Again, it is a mistake to underestimate the ability of euro area policymakers to engineer such a gradual process, even if starting with consolidating the framework for only the largest (cross-border) euro area banks.

The euro area crisis, as we have established, is a political crisis. Therefore, the most appropriate theoretical framework for analyzing it is game theoretical concepts describing strategic bargaining among multiple actors, as found in Schelling (1966), or broader considerations of strategic actions as described in Liddell-Hart (1967)—not macroeconomic theories like optimal currency area theory (Mundell 1961), the debt sustainability theorem (Chalk and Hemming 2000), or other equilibrium-seeking modeling exercises aiming to restore full employment as soon as possible.

EUROPE IS MORE SOLID THAN FINANCIAL MARKETS THINK

Perhaps the single biggest disagreement we have with many other analysts about the current situation in the euro area and the challenges facing policymakers is the time required for taking necessary political actions. Every three months or so since May 2010, we have read and listened to self-appointed financial market gurus and top international policymakers proclaim that European leaders have only three months to save the common currency. We believe that many have their own political and market positioning reasons for making such comments, so attach limited importance to them.

We are strong proponents of the euro area going as far as possible as soon as possible in completing the economic and monetary union—to stabilize Europe's own economies and mitigate the domestic human, social, and hysteresis costs of the current crisis but also to boost the global economy increasingly struggling under the weight of the uncertainty spreading from Europe. Given the Europeans' well-known adoration of President Barack Obama, it would be a cruel irony indeed if their leaders' inability to deal with the euro area crisis in a timely fashion were to end up costing him reelection!

While we believe that further euro area integration can be gradual, it is critically important that euro area leaders urgently make a firm political commitment to proceed much further with such gradualist integration. In other words, euro area leaders must soon convince markets and their own voters that their goals can and will be achieved over time. The same logic applies to the US federal budget crisis, where Congress must also take urgent and politically credible action now that will phase in medium-term consolidation over time.

7. Ibid, page 2.

8. First proposed by Christian Hellwig and Thomas Philippon, "Eurobills, Not Eurobonds," VoxEU, December 2, 2011, www.voxeu.org/index.php?q=node/7375, but since taken up legislatively by EU Parliament Member Sylvie Goulard. See "Explanatory Statement: non-official translation" at <http://sylvie-goulard.eu/eurobonds/31mai2012-eurobonds-explanatory-statement-EN.pdf>.

9. German Council of Economic Experts, "A European Redemption Pact," www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?&L=1.

10. See von Weizäcker and Delpla (2010).

11. European Commission, Green Paper on the Feasibility of Introducing Stability Bonds, Brussels, November 23, 2011, http://ec.europa.eu/economy_finance/consultation/stability_bonds/pdf/green-pepr-stability-bonds_en.pdf.

12. William R. Cline, "A Better Eurobond," op-ed in the *Wall Street Journal*, June 7, 2012, www.pii.com/publications/opeds/oped.cfm?ResearchID=2139.

The euro area has more time to fix its problems and is considerably more resilient than is generally perceived, for the following reasons.

First, when evaluating the recent macroeconomic performance in the euro area and growth prospects, it is necessary to make full provision for the fact that the euro area as a whole—like the United States and the United Kingdom—is suffering from the aftermath of a very serious financial crisis.

**We are strong proponents of the
euro area going as far as possible as
soon as possible in completing the
economic and monetary union....**

As shown definitively in Reinhart and Rogoff (2009), the expected cyclical recovery following this type of recession is considerably less vigorous than would transpire after a regular central bank–induced inflation-interest rates business cycle contraction.¹³ Combined with the long-term effects of population ageing in the euro area, it is important to keep the recent disappointing euro area economic growth performance in perspective. History tells us it can take five or even ten years for countries and regions to go through the required slow-growth deleveraging process that the euro area (as well as the United States and the United Kingdom) is currently experiencing. Relative to what should realistically be expected, therefore, the euro area is doing less badly than many assume.

Second, every euro area policymaker firmly believes that a collapse of the common currency is an utterly unacceptable and indeed unthinkable outcome and will—if required to—take every feasible step to avoid it. No European policymaker will want to go down in history as the one whose inaction undid 60 years of political and economic integration in Europe. This is particularly true in the case of Germany (where history and politics carry special significance). With persistently large trade surpluses, a pegged exchange rate against its nearest trading partners, and a presently relatively weak euro, Germany is among the euro members that derive the biggest benefits from the common currency. In the end, Germany's financial contribution to rescue the euro will reflect this self-interest.

Third, and related to the previous point, the ECB still retains far more financial firepower than is often perceived. As seen in figure 1, the ECB's total balance sheet since the beginning of the financial crisis has expanded relatively less

than those of the Federal Reserve and the Bank of England. Part of the reason is that even before the crisis, the ECB, as the central bank of a predominantly banking credit intermediated economy, had a substantially larger balance sheet as a share of GDP than the more market credit intermediated economies in the United States and Britain. In early 2008 the ECB balance sheet amounted to 14 percent of euro area GDP compared with just 7 percent of US GDP for the Federal Reserve and about 6 percent of UK GDP for the Bank of England.¹⁴

To evaluate what the ECB could do in extremis, it is more relevant to consider how the respective central banks have expanded their balance sheets since 2008. If the euro area crisis were again to enter an acute phase and threaten the future of the common currency, perhaps the most effective way for the ECB to intervene would be to engage in large-scale direct purchases of Spanish or Italian sovereign debt. It is important to note that, when compared with both the Bank of England and the Federal Reserve, the ECB/Eurosystem today owns far fewer securities outright. Figure 2 shows as a share of 2012Q1 GDP central bank holdings in the Eurosystem's portfolio of securities held for monetary policy purpose,¹⁵ the Bank of England's Quantitative Easing Asset Purchase Programme, and the Federal Reserve's securities held outright.

The Eurosystem currently owns assets amounting to only 3 percent of GDP, far less than the more than 21 percent of UK GDP purchased to date by the Bank of England and about 17 percent of US GDP held by the Federal Reserve.¹⁶ It is thus noteworthy that even a further €1 trillion in new ECB purchases of Spanish and Italian sovereign bonds would push

14. When measured as a share of GDP, the ECB balance sheet expansion since 2008 at 18 percent is comparable to the 17 percent of UK GDP expansion by the Bank of England but larger than the 12 percent of US GDP expansion by the Federal Reserve. Due to the much smaller starting balance sheet size for the Federal Reserve, its increase amounts to a considerably higher cumulative balance sheet growth than for the ECB. All data are from the ECB, Bank of England, and Federal Reserve.

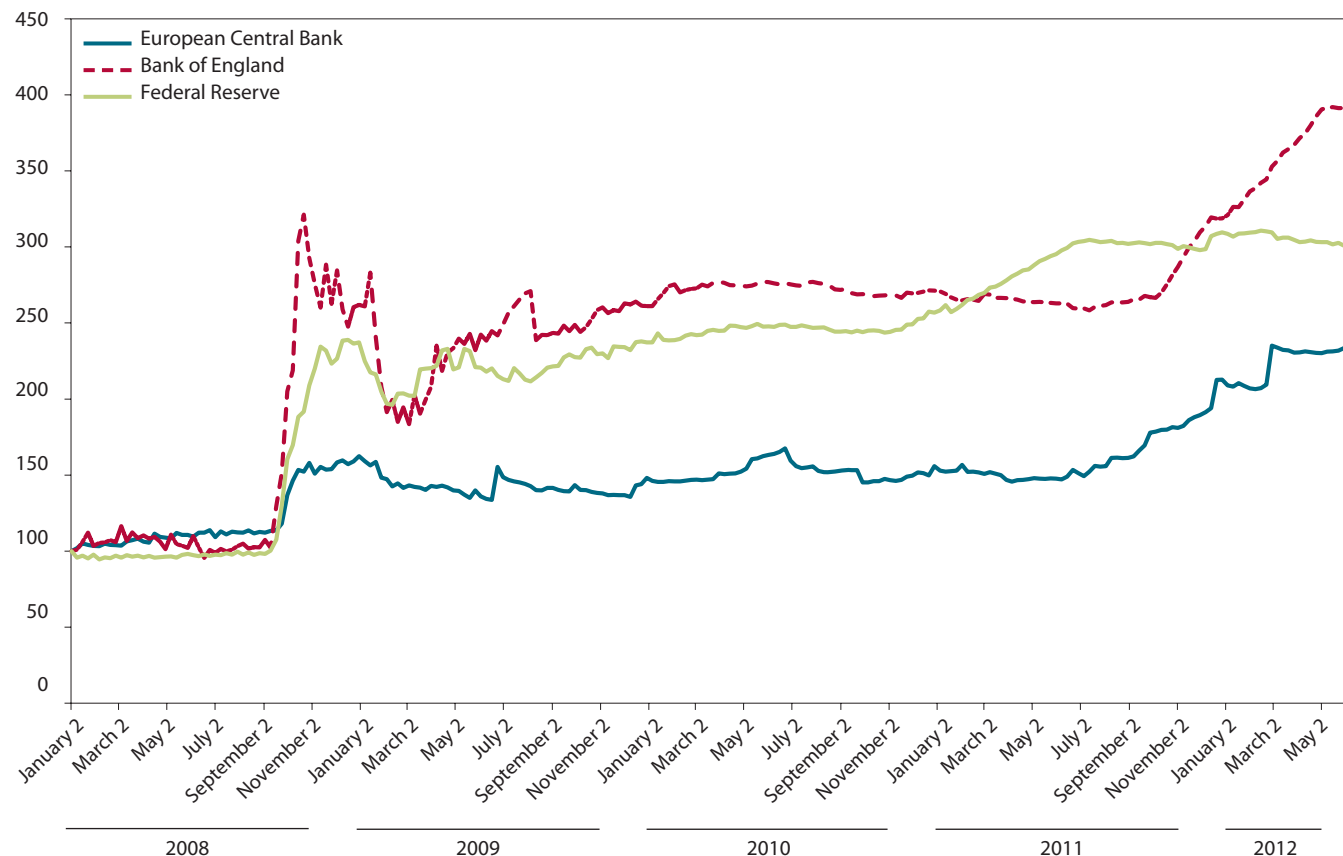
15. This includes assets purchased under the Securities Market Program (SMP) and the first and second covered bond purchase programs.

16. The recent large expansion of the ECB balance sheet from its about €1 trillion 3-year long-term refinancing operations (LTROs) is considerably less risky for the ECB balance sheet quality than is often understood. First, it comes in the form of repo exposures, which means that the ECB would suffer losses only if the euro area counterparty bank were to collapse. Given the ability of the ECB itself (or national central banks through Emergency Liquidity Assistance) to provide potentially unlimited liquidity to pretty much any euro area bank (not just solvent banks, as it officially claims), as well as its revealed political ability to force recalcitrant governments into accepting international bailouts intended to help recapitalize their banks (ask the Irish and Spanish governments!), this risk is less than meets the eye. Second, it is important to note that ECB liquidity is provided only against often substantial (up to 75 percent) haircuts on the provided collateral. For an elaboration, see "Bank Rescues Through the ECB?" Berlin, June 20, 2012, www.ecb.int/press/key/date/2012/html/sp120618.de.html

13. See also our late great colleague Michael Mussa's (2012) contribution on this subject.

Figure 1 Central bank balance sheet expansion, January 2008 to present

index (January 1, 2008 = 100)



Sources: European Central Bank, Bank of England, US Federal Reserve.

the total security holdings of the Eurosystem to merely 14 percent of euro area GDP—in other words, fewer assets than are currently held by the Bank of England and the Federal Reserve. We fail to see why the ECB would risk the demise of the common currency instead of owning slightly fewer government bonds, if required, than the Federal Reserve does today?

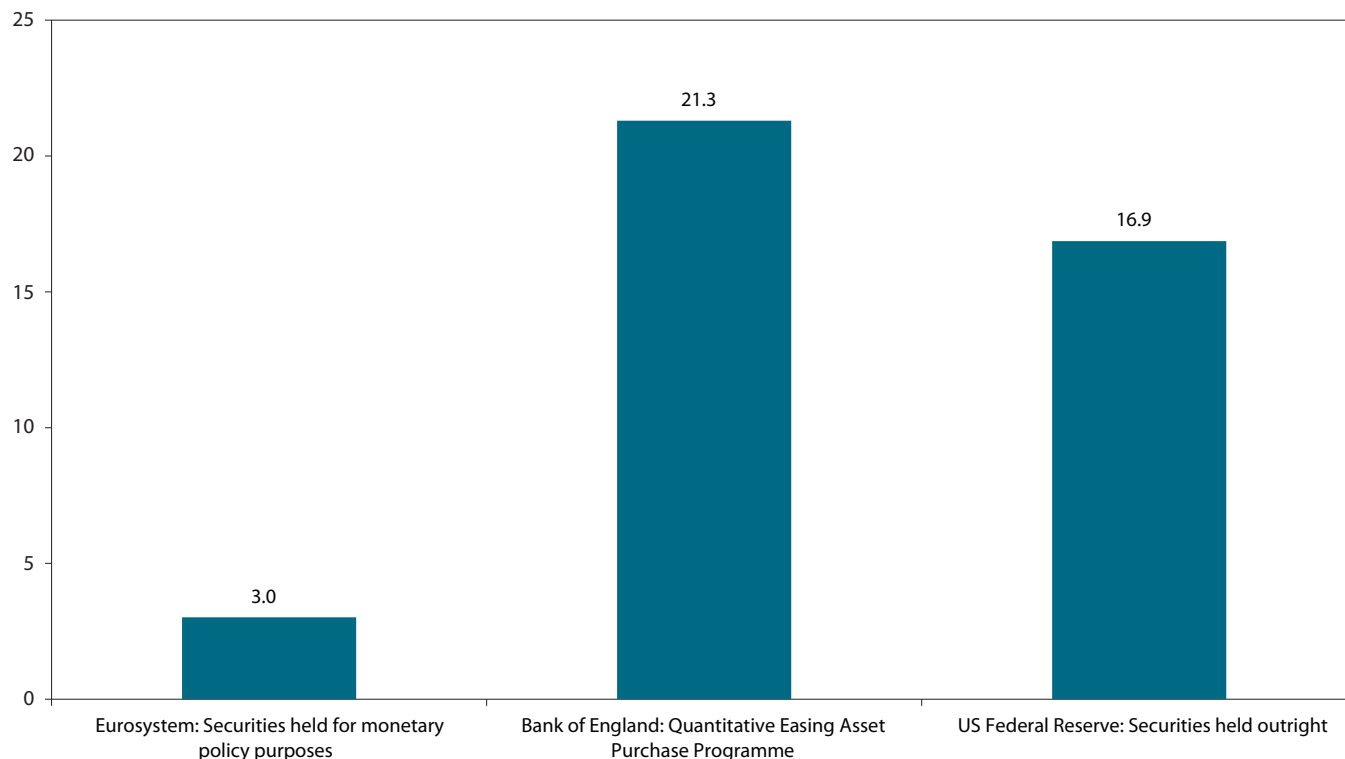
As discussed in Bergsten and Kirkegaard (2012), it is a grave mistake to think that the ECB’s relatively limited asset purchases to date reflect a fundamental inability or unwillingness to make interventions—if the survival of the euro were at stake—of a magnitude at least equal to its British and American counterparts. In fact, its limited asset purchases so far in this crisis reflect its unrivalled political power among central banks. In the absence of other euro area governance institutions, the ECB’s unique status as a de facto euro area economic government since early 2010 has allowed it to only partially deploy its balance sheet strength when euro area leaders have made credible austerity commitments (3-year long-term refinancing oper-

ations [LTRO] in return for agreement of the Fiscal Compact in December 2011), structural reforms (Securities Market Program [SMP] purchases of Spanish and Italian sovereign debt in return for national commitments to reform demands in secret letters to Prime Ministers Silvio Berlusconi and José Luis Rodríguez Zapatero in August 2011¹⁷), and institutional euro area deepening (establishment of the SMP and purchases of Greek, Portuguese, and Irish sovereign debt in return for the creation of the European Financial Stability Facility [EFSF] in May 2010).

17. Silvio Berlusconi subsequently reneged on his promise to implement the structural reforms contained in the letter from then ECB President Jean-Claude Trichet and Bank of Italy President Mario Draghi. This lack of reform commitment ultimately led to political demise in November 2011, as the ECB resisted making purchases of Italian debt of a magnitude to keep its long-term yields at a politically acceptable level. The leaked letter is available at www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml.

Figure 2 Central bank outright asset holdings, June 2012

percent of 2012Q1 GDP



Sources: European Central Bank, Bank of England, US Federal Reserve.

Since the ECB's principal political task in the crisis has been to coax and coerce European political leaders into taking tough political decisions and creating the necessary euro area institutions, it is critical to understand that the ECB always has to appear as institutionally and politically constrained in its potential future interventions as possible. Such an appearance is important to prevent self-interested euro area leaders from relying on the central bank to save the day, rather than biting the political bullet themselves. Note also that in this strategic interaction, having a "mad dog Bundesbank" constantly barking about all the things "the ECB can never do" is hugely politically beneficial to ECB President Mario Draghi and the rest of the ECB. They can simply tell petitioning euro area politicians that they are very sorry and cannot offer any help because of the intransigence of the Bundesbank. This ECB-versus-governments dynamic has been evident throughout the crisis and was most recently on display in the weeks before the Spanish government accepted the need to seek euro area financial assistance for its bank recapitalization. Prime Minister Mariano Rajoy repeatedly called for new ECB purchases of Spanish government bonds. In the end, the ECB said "no" and Rajoy had to reluctantly turn to the EFSF/ESM.

Yet, make no mistake. If the survival of the euro were really at stake, the ECB could, and without hesitation would, make even larger additional asset purchases to calm the situation: €1 trillion would buy quite a lot of time. Moreover, given its unwavering political commitment to preserve the euro, the German government would implicitly consent to such emergency ECB interventions.

The focus of market participants on the size of the euro area firewall is, therefore, a red herring. Market participants might claim a higher firewall as absolutely necessary (not least for their own financial security, as a bailout is always comforting), but a proper understanding of the financial capacity and political response function of the ECB, as we have laid out above, makes clear that it is largely irrelevant when the matter at hand is the survival of the euro.

Fourth, the domestic political situation in the euro area is far more benign than is generally perceived. It is often asserted that populist governments are on the cusp of taking over power in various euro area countries in response to recent economic hardships. That is far from being the case and represents a broad misunderstanding of the political trends in the

old EU-15 member states, partly excluding Greece. Indeed, the 1930s is a grotesquely misapplied historical analogy to the current political situation in Europe.

Greece represents a political outlier in Europe, as it suffers from both a serious economic crisis and a collapse of credibility of the entire established political system comprising the (historically extremely corrupt) parties of New Democracy and PASOK.¹⁸ It is not surprising that the recent elections there have led to the emergence of entirely new populist parties—such as Syriza—with very large public support. Due to the kleptocratic nature and historical dominance of New Democracy and PASOK, no credible established political party exists today to implement required economic reforms. And because of the urgent need for complete renewal of the Greek political system, the Greek electorate is denied the opportunity to vote for such a mainstream party. No wonder skilled populists like Alexis Tsipras, in the absence of alternatives, are proving so popular. But we should note that the last Greek election has produced a pro-euro and generally pro-reform government, indicating that even the discredited Greek political system can in the midst of a historic rebirth—when the alternative is the chaotic uncertainty of losing international economic support—produce a functioning government.

Fortunately though, no other euro area country suffers the same acute political credibility crisis as Greece (although Italy might come close in 2013). The actual election results in the rest of the euro area periphery since the beginning of the crisis verify this point. In the 2011 elections in Ireland, Portugal, and Spain, the incumbent governments were all kicked out of office. However, voters in all three countries explicitly rejected available populist alternatives and instead installed strong new majority governments from the parties most closely aligned with austerity and economic reforms. European periphery voters may vent their anger at politicians by kicking them out but make sure that roughly the same policies stay in place. Populism remains distinctly unappealing to the majority of voters across Western Europe, who prefer instead to change the coach but hold on to the same team tactics.

Other euro area countries like Finland, Netherlands, France, and Austria have in recent years seen the emergence of new populist leaders like Timo Soini of the True Finns Party, Geert Wilders of the Dutch Freedom Party, or Marine Le Pen from the French National Front. However, it is important to understand the common political platform of these new euro area populist parties. All espouse a mix of right-wing anti-

immigration and nationalist/anti-EU views, combined with traditional left-wing pro-welfare and anti-austerity policies. Considering the historically unprecedented levels of (economically beneficial) immigration that the euro area experienced in the decade before the global financial crisis (roughly double the inflow to the United States in the years before 2008), it is unsurprising that parts of the electorate respond in a xenophobic way. It is a mistake to simplistically attribute this voter response to euro area bailouts. Similarly, the (again, economically beneficial) abandonment of many now unaffordable welfare state policies by the traditional center-left parties have allowed the populists to claim these unsustainable but popular political causes for themselves. The current euro area political megatrend is not populism but rather a shift to the political center by Social Democrats in Northern Europe going back to the 1980s and 1990s and, since the crisis, also by Southern European Socialist parties. This long political transition has heralded a new era of general political convergence on fiscal and social policies between the European center-right and center-left. Many US-based observers overlook this trend perhaps because of the completely different political situation in the United States, where political divergence between the two parties has grown ever larger in recent years (Mann and Ornstein 2012).

In political systems with fewer ideological differences between the main parties and much greater policy continuity between center-right and center-left governments—consider, for instance, the difference between the policies implemented immediately by French Socialist President Francois Mitterrand in 1981 and by President Francois Hollande in 2012—it is unsurprising that populist parties that span both political extremes have emerged.

This development does not mean that these parties are close to claiming power in continental Europe's proportional representation multiparty electoral systems. In such systems, when there is general policy consensus between the center-right and center-left, the presence of even relatively sizable populist parties is largely irrelevant for the broad economic policies implemented. This is the case in Europe today. Populism is nothing new in Europe, but these political systems have historically been quite adept at dealing with the presence of populist electoral support exceeding that seen today. The French National Front, for instance, received 14.9 percent of the votes in the French first round parliamentary elections in 1997, more than the 13.6 percent it received earlier in 2012. Yet few would claim that France has been run by populists since 1997.

Europe's voters are both rich and growing older, which means they all have a lot to lose from irresponsible populist

18. "Corruption Case Hits Hard in a Tough Time for Greece," *New York Times*, May 2, 2012; "Why are Greek and Italian politicians so bad?" Reuters, May 24, 2012.

economic policies—such as a departure from the euro. There is consequently little reason to fear a swing in such policies in Europe. Considering the economic hardships and reforms being implemented, the current quite remarkable political continuity is here to stay.

Fifth, it is a mistake to believe that crisis-driven integration is inherently undemocratic or politically unstable. Steps to integrate Europe in times of crisis will invariably take on an “elite” character, as they are decided very quickly by governments in response to looming disaster, as opposed to being the result of bottom-up political initiatives from the European citizens. Many believe that this decision making makes such integration inherently politically unsustainable, as it is forced upon European voters at 2 a.m. before the Asian financial markets open. Numerous lost referenda show that Europeans from time to time wish to take the foot off the accelerator. However, we believe crisis situations are different and disagree with the assertion that new integration steps decided during crises are inherently undemocratic, politically unsustainable, and prone to collapse. In reality, they are likely to be as politically durable as integration decisions taken in normal political times.

The reason is two-fold. First, all euro area members have fully accountable representative democracies with variations of proportional representation parliamentary systems. If European voters were truly fed up with the degree of European integration thrust upon them by their elected representatives, they could simply vote them out at the next regular parliamentary election. However, the historical reality is that they never have. Whenever Irish, Danish, Dutch, or French voters have rejected an EU Treaty change at a referendum, the political parties that supported the treaty (invariably large parliamentary majorities) have always returned to power. It is a mistake to claim that repeated referenda or rapid European integration steps decided at times of crisis are inherently undemocratic. Instead, they represent the essence of legitimate European representative democracy. Europe has political systems where elected representatives take decisions on behalf of voters and are accountable to them at regularly held free elections, as well as subject to the national constitutional clauses for direct democratic participation (e.g., referenda). We see no reason why decisions taken in a crisis should be any different and are therefore confident that measures taken since early 2010 in the euro area will stand the test of time—as also illustrated by the recent Irish referendum approving the Fiscal Compact.

Second, and related to the first reason, European voters are generally schizophrenic and have illogical views on the relevant political issues in the current crisis. The recent Greek elections starkly illustrate this: Large majorities of Greeks both

profess a desire to stay in the euro area and oppose required austerity and economic reforms to do the same. Fortunately, times of crisis force people to choose between their inconsistent views. Recent crisis decisions to further integrate Europe have done precisely that. While Europeans might fret over the associated austerity, reform, and loss of national sovereignty, large majorities will be quite pleased with retaining the euro and their still generally high standards of living.¹⁹ Crisis decisions since 2010 have not really been about forcing more elite-driven integration down the throats of reluctant European electorates but instead about getting them to choose between the inconsistent viewpoints they can no longer afford to hold.

In that regard, the situation is reminiscent of that concerning the US federal budget deficit, where American voters on the one hand want to hold on to all the services the government currently provides but on the other hand do not want to pay the taxes to pay for these services. In the end, this logical inconsistency in the minds of Americans will have to be resolved to avoid a US sovereign default. Just as we fully expect US voters and a majority of their elected representatives to ultimately make up their minds about taxes and spending to avoid such a default, we fully expect Europeans to settle their inconsistencies and continue to elect representatives who favor completing the economic and monetary union in Europe.

WHAT THE EURO AREA NEEDS TO DO NEXT

While the euro is on a better footing than most believe, European leaders urgently need to take a number of very far-reaching political decisions, beginning at their summit on June 28–29 and during the rest of 2012.

In broad political terms, euro area member states need to hand over more of their national sovereignty to new euro area institutions to begin the process of completing the economic and monetary union. This handover, as laid out earlier, must be accompanied by a synchronized and proportional mutualization of euro area government debt liabilities and contingent liabilities. This political-financial quid pro quo will dictate the progress expected at the June EU Summit on the two key areas for further deepening of euro area integration: banking union and fiscal union.

19. Single-issue polling, which tends to drive most of the media commentary on the crisis, misses critical clarifications of illogical views. Much of the media commentary, therefore, is excessively alarmist about the euro area political outlook.

Banking Union

Immediate progress on the integration of the euro area's banking sectors is urgently required. First, it is necessary to appoint the ECB as the single euro area banking regulator with authority to overrule national banking regulators, a move that equals substantial handover of national sovereignty by euro area members. No government wants to lose control over its national banking system, but it is clearly required in present circumstances. The ECB will probably become the

In broad political terms, euro area member states need to hand over more of their national sovereignty to new euro area institutions to begin the process of completing the economic and monetary union.

sole regulator of only the largest and cross-border euro area banking institutions. Limiting the ECB's control this way would mitigate the loss of national sovereignty and establish a regulatory framework like that for the US banking system, where most smaller banks are state-chartered and the larger banks nationally chartered with different regulators but based on the same single supervision rulebook. Both the ECB itself²⁰ and German Chancellor Angela Merkel²¹ have expressed their support on this issue. The political economy of the euro area crisis so far has shown that when both the ECB and Germany want something, they get it.

Simultaneously, the European Union as a whole has been negotiating a new common resolution authority,²² with explicit provisions for bail-ins of shareholding capital and all uncollateralized/asset-backed liabilities—e.g., both subordinated and senior unsecured debt holders. In addition, guar-

anteed deposits, short-term interbank lending, client assets, salaries, pensions, and taxes would be excluded from such bail-ins.²³ These changes to “shield” European taxpayers from the fallout from future bank failures are critical to the shift toward pan-euro area banking resolution. Bondholder bail-in provisions are also a powerful tool to limit future cross-border fiscal transfers related to large bank bailouts in a fully implemented euro area banking union.

Thanks to the recent Spanish bank bailout, and the fact that the national banking systems of Greece, Ireland, and Portugal are all being recapitalized as part of IMF programs, a vast majority of the costs of cleaning up the peripheral euro area banking systems will already have been incurred and transferred to the national government balance sheets ahead of the June EU Council meeting. As with the introduction of EU bank bondholder bail-ins, these already incurred costs will lower future cross-border fiscal transfers from bank bailouts in a fully implemented euro area banking union. It is after all easier to integrate solvent, rather than insolvent, banking systems.

Bail-ins and already implemented peripheral bank restructurings will facilitate German agreement on the last and most critical part of a euro area banking union: reciprocal mutualization of contingent banking sector liabilities in the euro area in the form of a joint deposit insurance scheme modeled on the US Federal Deposit Insurance Corporation (FDIC) and a joint euro area bank resolution fund. Provided that agreement can be reached on the transfer of supervisory banking authority to the ECB, it is imperative that Germany fulfill its side of the bargain and agree to this reciprocal mutualization of related contingent liabilities. For a transition period, a dual level resolution and deposit insurance fund scheme may exist at both the national and euro area levels, with the national level funds taking first loss (eliminating any moral hazard) and euro area level funds called upon only subsequently. However, this phase would exist only until banking supervision is actively carried out at the euro area level, at which time full euro area contingent liability mutualization must occur. Initial financing issues may have to be overcome through the deployment of European Stability Mechanism (ESM) funds until a regular insurance-based model financed by the banking industry becomes self-sustaining.

We are encouraged by the G-20 Communique's statement from Los Cabos that “Euro Area members of the G20 *will* [rather than should or intend to; emphasis added] take all necessary measures to safeguard the integrity and stability of the area, improve the functioning of financial markets

20. Huw Jones and John O'Donnell, “ECB in line to oversee top European banks, Reuters, June 14, 2012, <http://in.reuters.com/article/2012/06/14/eu-banks-supervision-idINL5E8HE9RB20120614>.

21. See “German Govt: Need Stronger Banking Supervision In Europe, Preferably Under ECB,” *Wall Street Journal*, June 22, 2012, <http://online.wsj.com/article/BT-CO-20120622-703222.html>.

22. See “Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No. 1093/2010,” COM(2012) 280/3, http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf.

23. Member states can also choose to exclude other liabilities on a case-by-case basis if necessary to ensure the continuity of critical services.

and break the feedback loop between sovereigns and banks.” These carefully selected words make it less likely that euro area leaders can wiggle out of the commitment.

The critical issue is the so-called doom-loop between national banks and their sovereign governments, but several feedback loops exist with varying degrees of importance. One doom-loop is the negative spiral that emerges when banks become too big for their national governments to guarantee. This is what happened in Ireland and is the principal reason why supervision and resolution responsibilities for at least the largest banks must urgently be moved up to the euro area level. With the largest banks instead supervised and guaranteed by euro area institutions, the potential for simultaneous increases in the funding costs for sovereigns and their banks in individual member states should be reduced. It is therefore critical to set a “sufficient threshold” for the share of each national banking system lifted to the euro area level. Many smaller banks will retain their national regulator and (at least initially) be nationally guaranteed. However, enough of each member state’s banking system must be transferred to the euro area level to ensure that the remaining contingent liabilities for each member state do not immediately threaten the creditworthiness of the sovereign. Each country’s threshold will of course also be affected by the capitalization of banks (as well-capitalized banks will represent a less risky contingent liability for a government) and other issues. Ultimately it will at least partially be a market decision.²⁴ Establishing the right cut-off point for national versus euro area regulated banks may therefore change over time.

Breaking the doom-loop now is critically important. The pass-through from higher sovereign borrowing costs to higher funding costs for all banks (or vice versa in the case of Ireland and Spain), irrespective of their individual capitalization and financing costs for the nonfinancial sector, poses the biggest danger to economic growth in Spain, Italy, and the rest of the periphery. Introducing a banking union as soon as possible will be a sizable and urgently needed monetary stimulus for the euro area periphery.

A banking union would also allay concerns over high bank holdings of domestic government bonds. After all it is often said that high domestic government bond ownership is one of the beneficial stabilizing factors in Japan. If it is a good thing in Japan, why is it terrible in Italy? The reason is obviously excessive concerns over the solvency of the Italian and Spanish governments, for instance, made worse by potential

liabilities from Italian and Spanish banks. A banking union will remove many of these contingent liabilities from national balance sheets and should therefore quell concerns about no longer domestic banks but euro area banks holding sovereign debt. In sum, euro area leaders must focus their energies on integrating their banking sectors.

Fiscal Union

The second main issue on the agenda of the EU Council is fiscal union. Enormous political obstacles must be overcome to complete such integration. We are therefore less certain of concrete immediate progress on fiscal union than on banking union. As we discussed earlier, euro area countries should further transfer national sovereignty over fiscal policies and establish proportional mutualization of existing and future national sovereign debts. This can be accomplished in several ways: through eurobills, the European Debt Redemption Fund, Red Bonds/Blue Bonds, or other alternatives.

The key political difference between implementing a fiscal union and banking union is the new euro area institution into which sovereignty is transferred. Because of the complex technical nature of a banking union, the ECB as a competent technocratic and unelected institution is an adequate institution to assume these responsibilities. However, technocratic and bureaucratic institutions (like the European Commission in its current form) will not suffice in fiscal policy matters, since they concern fundamental political and distributional choices in society. Genuine fiscal policy competencies can be transferred only to a new euro area institution with direct democratic legitimacy. Designing such an institution and instilling the European Union/euro area with additional direct democratic legitimacy from the European population is a profoundly complex and time-consuming task. As illustrated by the Future of Europe Group, which consists of interested foreign ministers, first convened by Germany in March 2012,²⁵ European leaders have begun to debate this task.

At their June summit, EU leaders need to articulate the longer term direction of the euro area, spell out the 10-year plan for the common currency, as Mario Draghi has suggested,²⁶ and provide credible political assurances to markets and voters that the path will be followed. With banking union proving to be an immediately achievable goal, long-term visions should be about the design of the fiscal union and the accompanying transfer

24. Since banks themselves will finance the resolution and deposit insurance funds in the long run through a fee-based insurance model, it is for less relevant reasons of long-term redistribution and implicit fiscal transfers that some countries might have more large banks regulated at the euro area level than others.

25. Federal Foreign Office, “Meeting of the Future of Euro Group in Berlin,” www.auswaertiges-amt.de/EN/Europa/Aktuell/120320-Zukunftsgruppe.html.

26. Introductory statement to the press conference (with Q&A), Mario Draghi, President of the ECB; Vítor Constâncio, Vice-President of the ECB, Frankfurt am Main, June 6, 2012, www.ecb.int/press/pressconf/2012/html/is120606.en.html.

of national sovereignty (political union). Achieving a banking union in 2012 will be an economically appropriate and politically feasible downpayment on a long-term fiscal union vision.

Given that Europeans continue to identify themselves as citizens of their respective member states (rather than of Europe as a whole), a large tax-financed centralized euro area budget similar to the US federal budget remains utterly unrealistic. A euro area fiscal union would be far more decentralized in terms of where the taxing and spending occurred (e.g., overwhelmingly at the member state level, not at the central level as in the United States). But that does not mean mutually agreed rules, overseen by a euro area political entity, cannot dictate revenue generation and spending of member state governments.

Indeed, this process is already well under way through the European Semester, the Six-Pack, and the Two-Pack, all of which give the European Commission far more direct oversight of how member states spend their own money than that enjoyed by the US federal government over US states. Much of US state government spending follows federal government mandates, as federal grants come with strings attached, but that is because most of the US government's taxing power resides with the federal government (after all, Americans identify more with being American than as residents of their states). But in a euro area fiscal union money would be raised and spent at the member state level, and the strings would be in the form of elaborate EU or euro area fiscal rules applicable to all member states.

Such centralized fiscal policy oversight of taxing and spending decisions of democratically elected governments cannot credibly be carried out by unelected bureaucrats. The EU/euro area fiscal overseers will therefore need to be elected by the entire EU/euro area population to gain direct democratic legitimacy. Given the tremendous new fiscal oversight already granted to the European Commission since the beginning of the crisis, if the new EU Fiscal Compact rules are ultimately to be adhered to, transfer of democratic legitimacy is probably already required in the long term. A democratically elected overseer in Brussels would have a better shot at staring down even the French president over fiscal policy disputes.

CONCLUSION

Our “only on the brink” strategy for European integration is inherently risky and indeed cannot succeed without the risk of miscalculation and catastrophic mutual failure leading to solutions. But for reasons discussed in this Policy Brief we believe this risk is very small and exaggerated by most commentary.

The EU Council on June 28–29 must begin a new stage of European integration by taking long-term decisions on banking and fiscal union. We are certain that these political

discussions of the tradeoffs between the handover of national sovereignty and debt and contingent liability mutualization will also produce side agreements on Europe's recently created crisis-fighting institutions, the EFSF/ESM—and when governments hand over additional national sovereignty, the ECB—to help quickly stabilize the European financial markets and real economies across the periphery.

Only two things seem certain in this crisis: that the euro will survive and emerge stronger from the crisis and that, given the fundamental differences between Europe and America, the euro area fiscal and political union will not look anything like the American one. Fortunately, it does not need to.

REFERENCES

- Bergsten, C. Fred, and Jacob F. Kirkegaard. 2012. *The Coming Resolution of the European Crisis*. Policy Briefs in International Economics 12-1. Washington: Peterson Institute for International Economics.
- Chalk, Nigel, and Richard Hemming. 2000. *Assessing Fiscal Sustainability in Theory and Practice*. IMF Working Paper WP 00/81. Washington: International Monetary Fund.
- Duval, Romain, and Jørgen Elmeskov. 2005. *The Effects of EMU on Structural Reforms in Labour and Product Markets*. OECD Economics Department Working Paper 438. Paris: OECD Publishing.
- Kruse, D. C. 1980. *Monetary Integration in Western Europe: EMU, EMS and Beyond*. London: Butterworths.
- Liddell-Hart, Basil H. 1967. *Strategy*. London: Faber & Faber Ltd.
- Mann, Thomas E., and Norman J. Ornstein. 2012. *It's Even Worse Than It Looks: How the American Constitutional System Collided With the New Politics of Extremism*. New York: Basic Books.
- Mundell, Robert A. 1961. A Theory of Optimum Currency Areas. *American Economic Review* 51, no. 4 (September): 657–65.
- Mussa, Michael. 2012. Challenges to Economic Recovery in the United States and Europe. In *Transatlantic Economic Challenges in an Era of Growing Multipolarity*, ed. Jacob F. Kirkegaard, Nicolas Véron, and Guntram Wolff. Washington: Peterson Institute for International Economics and Bruegel.
- Reinhart, Carmen, and Kenneth Rogoff. 2009. *This Time It's Different: Eight Centuries of Financial Folly*. Princeton: Princeton University Press.
- Schelling, Thomas C. 1966. *Arms and Influence*. New Haven: Yale University Press.
- von Weizsäcker, Jakob, and Jacques Delpla. 2010. *The Blue Bond Proposal*. Bruegel Policy Brief 2010/03. Brussels: Bruegel. Available at www.bruegel.org/publications/publication-detail/publication/403-the-blue-bond-proposal.
- Williamson, John, ed. 1994. 1994. *The Political Economy of Policy Reform*. Washington: Institute for International Economics.
- Wolf, Dieter. 2002. Neofunctionalism and Intergovernmentalism Amalgamated: The Case of EMU. In *The Euro: European Integration Theory and Economic and Monetary Union*, ed. Amy Verdun. New York: Rowman & Littlefield.

The views expressed in this publication are those of the authors. This publication is part of the overall programs of the Institute, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board or the Advisory Committee.