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The European Union in Crisis

Meltem Müftüler-Baç

The European Union's monetary integration was one of the most ambitious steps towards the realization of a common market in 1992. The Treaty of Maastricht laid down its ground rules, specifically the convergence criteria for the qualification of the individual currencies, and the gradual integration of the Central Banks proceeded along these lines in the 1990s. Ultimately, the adoption of the euro in 1999 presented a critical step in the European integration process. The introduction of the euro as the common currency and the elimination of national currencies from circulation were radical steps, signalling a transfer of competencies from the national centres to the supranational authority on one of the most critical symbols of statehood-one's own currency.

Meltem Müftüler-Baç is Jean Monnet Professor at the Faculty of Arts and Social Sciences of Sabancı University and Senior Scholar at Istanbul Policy Center.

Contact Information:
Sabancı University
Orhanlı – Tuzla 34946, Istanbul
+90 216 4839247
muftuler@sabanciuniv.edu

The euro entered the circulation in 2002, and as of 2012 there are 17 EU members- with the exception of UK, Denmark and Sweden- in the euro zone with no new member state allowed to have a opt out from the euro if they meet the convergence criteria. The institutional direction to the euro is provided by the Eurogroup, which is composed by the finance ministers of the 17 euro zone countries, currently headed by Jean Claude Juncker.

The euro experienced a rosy economic performance in its first 5-6 years but by 2008, a major economic crisis was underway. Since 2008, the European Union confronted one of its worst economic and financial crises. The financial meltdown that began in the United States diffused into the European market, exacerbated by the weak economic performances and public debts of some of the euro zone members. The economic crisis in the European Union is one of the most important developments in the European integration process shaping the EU's future. The following table, Table 1, summarizes the economic performance of the EU members and illustrates the divergence within the EU in terms of public debt, budget deficit and growth rates.

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Table 1: economic performance of the EU27 in 2011

Member State	GDP USD billion $ (2011)	Annual change % of GDP (2011)	GDP per capita in PPP US$ (2011)	Public Debt % of GDP (2011)	Budget Deficit % of GDP (2011)	Unemployment % 2012 M9	Growth rates 2011
Germany	3,577.0	3.0	37,897	81.2	-1.0	5.4	3.0
France	2,776.3	1.8	35,156	85.8	-5.2	10.8	1.7
United Kingdom	2,417.6	0.8	36,090	85.7	-8.3	7.9	0.9
Italy	2,198.7	0.4	30,464	120.1	-3.9	10.8	0.4
Spain	1,493.5	0.7	30,626	68.5	-8.5	25.8	0.4
Netherlands	840.4	1.2	42,183	65.2	-4.7	5.4	1.0
Poland	513.8	4.3	20,334	56.3	-5.1	10.1	4.3
Belgium	513.4	1.9	37,737	98.0	-3.7	7.4	1.8
Sweden	538.2	3.9	40,394	38.4	0.3	7.8	3.9
Austria	419.2	3.1	41,822	72.2	-2.6	4.4	2.7
Denmark	333.2	1.0	37,152	46.5	-1.8	8.1	0.8
Greece	303.0	-6.8	26,294	165.3	-9.8	25.1	-7.1
Finland	266.6	2.9	36,236	48.6	-0.5	7.9	2.7
Portugal	238.9	-1.6	23,361	107.8	-4.2	15.7	1.4
Ireland	217.7	0.9	39,639	108.2	-13.1	15.1	1.4
Czech Republic	215.3	1.7	27,062	41.2	-3.1	6.8	1.9
Romania	189.8	2.5	12,476	33.3	-5.2	7.1	2.5
Hungary	140.3	1.7	19,591	80.6	4.3	10.6	1.6
Slovakia	96.1	3.3	23,304	43.3	-4.8	13.9	3.2
Luxembourg	58.4	1.1	80,119	18.2	-0.6	5.2	1.7
Bulgaria	53.5	1.7	13,597	16.3	-2.1	12.4	1.7
Slovenia	49.6	-0.2	28,642	47.6	-6.4	8.4	0.6
Lithuania	42.7	5.9	18,856	38.5	-5.5	12.9	5.9
Latvia	28.3	5.5	15,662	42.6	-3.5	15.9	5.5
Cyprus	24.9	0.5	29,074	71.6	-6.3	12.2	0.5
Estonia	22.2	7.6	20,380	6.0	1.0	10.0	8.3
Malta	8.9	2.1	25,428	72.0	-2.7	6.4	1.9

Source: World Economic Outlook, April 2012

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As the above table demonstrates, even though the EU members are relatively well off, some of them have significant public debts and low economic growth. This is perplexing given the fact that the Maastricht convergence criteria were very strict. In order to qualify for the common currency, the EU members had to have less than 60% of their GDP as public debt, budget deficit less than 3% of its GDP and less than 1.5% inflation. It seems now certain that some of the EU members should not have been included in the euro to start with. A significant cause of the current euro crisis then could be seen as the acceptance of certain members who did not meet the criteria into the euro zone. The next section addresses this issue through the case study of Greece.

The Greek tragedy

One of the biggest shocks to the European economic order came from Greece when it became obvious in 2008 that its public debt was around 185% of its GDP and that it distorted its economic indicators[1] and gave the European Commission manufactured data in order to qualify for the euro zone in 2001.[2] In 2001, the Greek government reported its budget deficit to be around 3% of its GDP, when in reality it was close to 7%. According to the Greek Prime Minister at the time Costas Simitis, "We all know that our inclusion in EMU (European Monetary Union) ensures for us greater stability and opens up new horizons."[3] Since then, with intense borrowing and no competitive industry, Greece in the past 10 years accumulated a large public debt-185% of its GDP and an astonishing 15% of its GDP as its budget deficit, the highest in the world- which again according to Maastricht rules should not be more than 3%. The Greek budget deficit has not been less than 6% in 2001, or in 2000.

Given this data, the decision to include Greece into the euro zone was perplexing. However, as stated by the European Commission spokesman Gerassimos Thomas in 2010: "Greece's admission to the euro zone was done on the basis of the convergence report which was established at the time and on the basis of figures and the statistical methodology applied at that time. It wasn't in question at that time."[4] To make matters worse, in early 2010, it was found out that the Greek government asked an American investment firm to use specific methodology and shift its debts to the future, and by doing so decrease its deficit. Specifically, "Goldman Sachs helped the Greek government to mask the true extent of its deficit with the help of a derivatives deal that legally circumvented the EU Maastricht deficit rules."[5] The Greek problem became a critical development shaping the other members' views on the European integration."[6] Over the past 10 years, the Greek debt spiralled upwards and it has currently the lowest ranking in the world in terms of credit worthiness. This is also surprising that an EU member in the euro zone has the lowest ranking since the euro as a major currency should be able to protect a euro zone member from such a fate. Since a significant portion of the Greek debt is to European banks, the situation potentially destabilizes the banking structure in Europe as a whole and not only in Greece. The way to get out of debt for a country would be to boost its income through trade and/or sale of its assets. This is the reason why the EU members putting money into Greece's bail-out plan are asking for privatization of state owned assets in Greece and sale of its assets along with structural reforms to strengthen its

economy. The lack of a manufacturing sector or a competitive industry in Greece does not loom well for its economic future. The manifestation of this financial crisis in Greece, however, is not only felt economically but it was deeply felt in the political arena as well with the Greek public turning against the European Union and putting the blame for their troubles on the 'European' agencies. All throughout 2010 and 2011, the Greek public demonstrated against the EU and IMF austerity packages.[7] This is despite the fact that the EU adopted along with the IMF two different bail out packages for Greece, one in 2010 for 110 billion euros and the second one in July 2011. Both of these packages were adopted amidst serious debates among the EU members, with the richer countries complaining about the lack of structural reforms in Greece that would be needed to prevent the reoccurrence of such crisis. The Germans and the Dutch, argue that Greece does not adopt the structural reforms and the austerity packages necessary to cut down its enormous debt but rely on the EU help to rescue them.

For example, according to reports in the British and other European media, the problems in Greece are in their current work system, as illustrated by the following: "the public sector workers are virtually unsackable, can retire as early as 45 and get bonuses for using a computer, speaking a foreign language and arriving at work on time…Some of them get as many as four extra months' salary a year, compared with the 14 months that are paid to other Greek workers."[8] This is the reason why the Germans are angry for paying for ills in another country while they stick to strict economic discipline. For example, the German Chancellor Angela Merkel declared in July 2011 that "We'll bail you out a second time. But if you want cash in future, you must work longer. We can't have a common currency where some get lots of vacation time and others very little. That won't work in the long term."[9] This declaration also sums up the perceptions among the Northern EU member states which tend to see the Southerners as lazy, irresponsible, and spend drift. The Southerners, on the other hand, see the Northern states, mostly Germany, as controlling, bossy and self-righteous.[10] There is now increasing referral in the Southern member states of the EU to Germany's Nazi past. This debate reached its peak in February 2012 with the German proposal for sending a 'fiscal controller' to Greece to supervise its budgetary planning.

A large part of the Greek problem is that it has very low economic growth rates and no competitive industry, i.e., it does not have a sustainable, continuous source of income. As a result, it is hardly surprising that it relies on the EU bail out plans to survive. On the other side of the coin, there are EU member states such as Germany which relies on its exports for its sustained economic growth and the prudence of its domestic consumers. The low domestic demand in Germany is one of the key factors in keeping the German accounts in constant surplus- around 5.2% of its GDP. With low domestic demand and a high level of exports, Germany maintains its economic

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superiority in the continent. Nonetheless, the budget deficits in the south and the budget surpluses in the north in the EU are mutually reinforcing each other, as it is 'spendthrift' Southerners who buy Germans products as well. As the periphery's capacity to make necessary structural adjustments was seen doubtful, the capital continued to leave the Southern Europe for safer destinations.

It is also for this reason that it seemed throughout the crisis that the German economy benefitted from the high discipline of its public where the public saves its earnings rather than put it all in consumption, and German exports are of such quality that the German economy continues to grow with high demand for its exports both within the EU and at the global level. However, the trend in Greece is just the opposite with high consumer demand for imports, low levels of savings and no industrial production. In other words, Germany also benefits from the high demand in the southern countries. On the other hand, since German products are in high demand all over the world, the German economy does not purely rely on the European demand to continue growing. This also demonstrates the diverging preferences among the EU members- Greece and Portugal rely on the EU for their economic survival, Germany or Sweden does not. Yet, the problem facing the EU members could only be solved collectively and at the EU level. This brings forth the question; what kind of an institutional response did the EU develop to deal with the euro zone crisis?

The Institutional Responses in the European Union

The economic crisis in Europe most probably would have been less traumatic if the EU's institutional mechanisms to deal with such a crisis were in place. Institutionally, the Greek debt problem also affects the European Union, as the only problem is not that Greece qualified for the euro zone on manufactured data, but that this was not noticed. The fact that these figures were not checked by the European institutions decreases the credibility of the EU as a whole but it also shows that the euro zone was launched without proper auditing mechanisms in place.[11] The debt crisis indicated the need for institutional check mechanisms. This is also partly why, the EU tried to respond relatively quickly with coordinated action, Commission proposals and the creation of a new institution, the European Financial Stability Facility in May 2010.

First, the bail out plans constituted the first leg of the EU's response to the economic meltdown in the European periphery. As indicated in the above section, Greece, for example, received 110 billion euros in 2010 and in 130 billion euros in 2011 and Spain received 100 billion euros in June 2012 for its banking sector. Second, the European leaders approved on 9 May 2010 a rescue package worth €750 billion aimed at ensuring financial stability across Europe and created European Financial Stability Facility. Third, the eurozone members agreed in October 2011 that private banks would accept a 53.5% write-off from the Greek debt and the deal was finalized in February 2012. Similarly, the EFSF was increased to €1 trillion, and euro zone members adopted a decision requiring European banks to achieve capitalisation for 9% in 2012.

In July 2012, the European Financial Stability Facility was replaced by a more permanent structure the European Stability Mechanism to act as a bail out tool. These were all very critical steps to ensure that the euro crisis would not have deepened. However, as early as 2008, a rift between the large member

states-UK, France and Germany- was visible in terms of the most preferred action plan to deal with the financial uncertainty.

This is also partly related to the fact that the euro zone countries were not ready for a financial crisis of this magnitude and an institutional mechanism to deal with euro zone problems of this sort did not exist. As a result, some European leaders stressed the need to adopt new measures and new institutions to deal with the financial crisis as summarized by the former French president, Nicholas Sarkozy as: "Our ambition is to seize the Greek crisis to make a quantum leap in euro zone government ... we need 'bold and ambitious' plans to create an embryonic EU finance ministry in the form of a European Monetary Fund".[12] The EU already adopted a similar mechanism in 2010. There was also a divergence within the euro zone over this mechanism as well, with the Germans insisting on its life duration to be relatively short. However, just to build a common institutional mechanism to deal with such problems is not a sufficient cure. There emerged significant differences among the EU members which accounted for the lack of a collective, coherent response from the EU institutions and the absence of a coordinated position among the members at least at the very beginning.

This incoherence probably is more crucial for EU integration than the economic crisis itself. What is more, one of the unexpected developments in the euro crisis was the rise of Germany as the critical player in Europe. In October 2010, at the European Council summit, the German Chancellor Angela Merkel determined the main agenda of the summit by her emphasis on three key issues, "tightening rules on economic governance, setting up a new institution to deal with countries unable to borrow in the markets, and revising the EU treaties." It also should be noted here that Germany along with China has resisted American plans to address the global imbalances in growth in G-20 meetings. This development also was critical in demonstrating the limits of joint action by the EU members at the global level.

One needs to keep in mind that there are, as in every EU policy, diverging preferences of the member states that block any meaningful response to the euro zone crisis. The euro zone members such as Spain and Italy, facing very high borrowing costs, argue that these costs they face come from the risks of convertibility and they request the ECB to deal with these risks. On the other hand, the other countries that enjoy low costs such as Germany, Austria, Finland, and the Netherlands argue that the problems that these countries face are their own responsibilities and their inability to adopt any structural reforms that would have boosted confidence in the markets about their commitment to change.[13]

It seems apparent that there is now a differentiation between these countries based on their economic growth and the health of their public finances. This argument ties to the observation that the relative lack of differentiation between the euro zone members prior to the financial crisis enabled those members with public finance problems to free ride on the economic performance of those members which had strict public finance regulations. Therefore, the investors and the markets are differentiating between those members who did their homework and adopt the necessary reforms versus those that did not. In addition, there is the looming possibility that eventually Spain, Italy and Greece would be forced out of the euro zone and the risk is too great to continue in lending

these countries money. In a self-fulfilling prophecy, this leads to increased interest rates making it more likely for these countries to go for default. This becomes a vicious cycle out of which these countries cannot get out on their own, and requires an EU level response.

Mario Draghi, the President of the European Central Bank, has revealed the EU's position on the euro crisis by affirming that "The Central Bank will do everything necessary to save the euro." This includes, of course, the adoption of a bond buying program and measures that would necessarily increase the markets' trust in the eurozone. However, a major complication in the eurozone and for this proposal is posed by the very high borrowing costs of Spain and Italy and the pending bankruptcy of Greece. As long as these countries are under such debt burden, their ability to adopt measures to boost economic growth is extremely limited. Consequently, a critical matter in the European Central Bank's ability to foster confidence in the markets and the sustainability of the eurozone ties to the German government's and German Bundesbank ability to commit to the plan. This is precisely why the ECB's bond buying programme might be God send, whether it is sufficient for the rescue remains to be seen.

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Since bail out plans and ECB bond buying are limited measures, the EU response took an institutional turn in 2011. In the December 2011 summit of the European Council, the EU leaders agreed to adopt new rules for tighter budgetary discipline and the main framework for a possible 'Fiscal Union'. The British government vetoed this plan in order to keep the City of London, its financial centre, unburdened by an extra layer of financial rules. The EU members, except UK and the Czech Republic, signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union on 2 March 2012. This was an important step towards the adoption of new measures for stricter control of financial discipline, and fiscal union. The Treaty is an intergovernmental treaty, signed outside of the EU legal framework, however, once the Treaty becomes operational with the ratification of at least 12 countries out of the 17 members that are already in the eurozone, the Fiscal treaty would then allow fiscal rules to become incorporated into EU law. There are a number of important steps taken with the treaty with regards to fiscal discipline. First, the treaty foresees automatic sanctions for those euro zone members who exceed the 3% of the GDP ceiling for the budget deficit with an amendment for the Article 126 of the Treaty on the European Union. Second, it requires the member states to submit their national budgets to the European Commission for consultation prior to their submission to their national parliaments. It is also possible to see that the Treaty was a precondition for the euro bonds that might be needed for stabilizing the eurozone and bring the periphery out of debt. It is, however, without doubt that the EU is now adopting supranational governance measures to deal with fiscal problems in its member states.

The European Commission would like to increase its ability to control the euro zone

members by placing certain countries in debt under a surveillance system and regularly review its economic and financial policies as a precondition for transfer of an EU funds to these countries. Particularly important here is that the European Commission would then be able to monitor the member state's statistical reports, an important measure that had it existed in 2001 would have captured the Greek misrepresentation. The EU's increased auditing, however, would constitute a serious transfer of member state's competencies to the EU. Yet, this was not an independent move from the national governments. Germany, Finland and the Netherlands would like to see strict rules on fiscal management and sanctions to those that violate these laws. Specifically, Germany stressed the need to have the EU executive, the Commission, to control national budgets and have the authority to veto those that blatantly breach the EU rules. This is reflected by the German Chancellor Merkel in 2012 as: "We have made good progress on strengthening fiscal discipline with the fiscal pact but we are of the opinion, and I speak for the whole German government on this, that we could go a step further by giving Europe real rights of intervention in national budgets."[14] This would be a more drastic step than the current plans for a 'banking union' at least for the eurozone countries. The first step to do that is to appoint a 'banking supervisor' that would be responsible for all the banks in the euro zone. The negotiations on this plan are finalized in December 2012, and the EU agreed on a Single Supervisory Mechanism in December 2012 that would act as the main mechanism for banks access to the European Stability Mechanism. This now means that the EU would have supervisory control over the failing banks in the euro zone. Furthermore, the EU would have increased control over euro zone banks that would all be placed under the supervision of the European Central Bank from 2014 onwards. Of course, this is a drastic move involving tighter monetary control by the EU on the national governments, clearly increasing the EU's role in fiscal management.

Conclusion

To the observors of the European Union, it came as no major surprise when the EU institutions began to acquire a prerogative to monitor national economies and budgets from 2011 onwards. The main step towards that goal was already taken with the March 2012 Treaty. The Fiscal Union plan gave the EU institutions the authority to supervise national budgets in line with the EU rules. This could be seen as a first step in this endeavour as more emphasis was increasingly placed on the EU institutions' role in establishing a banking union.

In short, the European Union responded to the euro crisis with institutional innovations and through the adoption of measures that aim at addressing the root of the problem. However, precisely because of the very nature of decision making in the EU, most of these responses were directly influenced by the diverging preferences of the EU members leading to suboptimal results. It seems the European Union needs both a clear strategy to build economic cohesion among its members and a collective view of common destiny. In the absence of both, the EU was plagued by indecision and internal strife.

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