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Eurozone Crisis and the Future of European Integration

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Introduction

One thing seems clear, despite all the uncertainty surrounding the current sovereign debt crisis in the eurozone: it will leave its mark. Whether it will indeed be a watershed and mark the next big leap forward towards an ever closer real Union or instead signify the further fragmentation of a multi-speed Europe is currently impossible to foresee. However, it seems very unlikely that it will be the beginning of the end of the European Union. The history of the European Union offers many examples of "using a good crisis" and making the best out of it and despite concerns over a core and periphery of EU states also in decision making: the longer the crisis lasts, the more likely that the EU will grown closer, not further apart.

The currently ailing economies of Greece, Portugal and to a smaller extent Ireland, Spain and Italy, have become a real test for the functioning and the determination and conviction of Europe's leaders. For the first time since the failed attempt to give Europe a constitution four years ago, the heads of states of the EU members are forced to finally act and steer the eurozone (and the EU as a whole) out of murky waters. Maintaining the status quo is no longer possible with Greece, Portugal and Ireland as recipients of EU and International Monetary Fund (IMF) bailout money. Even though the countries account for a mere six per cent of the EU's gross domestic product,[1] the fear of contagion and the devastating effect a default of an eurozone member would have on investor trust and markets makes it necessary to ensure a) better supervision of member state budgets and implementation of corrective mechanisms in case of foreseeable violation of the new and stricter Growth and Stability rules as well as the Maastricht criteria, b) closer coordination between member states in the field of labour market rules, social affairs, and most importantly fiscal policy and c) a gradual creation of the necessary institutions to ensure that the EU is able to assist member states in trouble more effectively and timely. Before these issues are elaborated in more detail, a number of other factors need to be addressed. Following a brief summary of the development of the eurozone crisis, the role of EU leaders in the shaping of any future solution needs to be highlighted. Their understanding of the EU determines how and to what extent support for more, or reversely, less Union can be expected from member states. Another factor of importance is the support political leaders enjoy in their countries, as more support will allow a more pro-European engagement, whereas narrow majorities or lack of support will result in a more critical or even anti-EU stance.

1 K. Rogoff: "The Euro's PIG-Headed Masters". *Project Syndicate,* http://www.project-syndicate.org/commentary/the-euro-s-pig-headed-masters, 3 June 2011.

Background of the Eurozone Crisis

The current ongoing eurozone crisis is often traced back to early 2009 when global financial markets grew increasingly worried about the growing sovereign debt levels around the world.[2] Concerns about the inability to service debt was amplified throughout the year by a series of credit rating downgrades by U.S. rating agency giants Moody's, Standard & Poor's (S&P) and Fitch.[3] Fear spread throughout the EU when it became apparent that Greece, following the first slashing of its credit rating, was spiralling towards state default, unable to service its debt. The Greek government's request for a joint EU/IMF bailout package in April 2010 saw the interest rates of the country's two-year bonds soar to over 15%[4] after S&P, but also Moody's and Fitch, downgraded its sovereign rating to "junk" status.[5] Investors, banks and credit rating agencies did not believe the announcements that the bailout package would be sufficient to help Greece return to a more sustainable economic policy, and they were proven right in early May when the country declared it would apply for a three-years €110bn loan, more than twice the original €45bn loan Athens had requested only a week earlier.[6] All eurozone countries, except for Slovakia, contributed to the bailout, which was not yet handled by the newly established European Financial Stability Faculty (EFSF).[7] Despite austerity measures, severe pay cuts and other attempts to regulate sovereign debt, the Greek economy fell into a deep recession which made a second bailout package unavoidable in October 2011.

Greece was not the only eurozone country to be hit severely by the increased distrust of the markets and the ratings agencies. In November 2010 Ireland had to request help from the EU and the IMF (as well as Britain, Denmark and Sweden) to avert defaulting on its debt.[8] Unlike in Greece where government over-expenditure had caused the crisis, combined with an end of the boom in tourism and ship-building in the late 2000s, Dublin's

2 "The Euro Zone's Debt Crisis: The Cracks Spread and Widen". *The Economist*, http://www.economist.com/node/16009119, 29 April 2010.

3 D. Bates: "Greece has Credit Rating Downgraded to 'junk levels' amid Fears over Ballooning Debt". *The Daily Mail*, http://www.dailymail.co.uk/news/article-1236525/Greece-credit-rating-downgraded-amid-fears-ballooning-debt.html, 17 December 2009. Greece's credit rating was slashed by S&P from A- to BBB+ with negative outlook in December 2009. A week earlier already rating agency Fitch had downgraded Greece. H. Smith: "Financial Markets Tumble after Fitch Downgrades Greece's Credit Rating". *The Guardian*, http://www.guardian.co.uk/world/2009/dec/08/greece-credit-rating-lowest-eurozone, 8 December 2009.

4 "Greek Credit Status Downgraded to 'Junk'". *BBC*, http://news.bbc.co.uk/2/hi/business/8647903.stm, 27 April 2010.

5 R. Wachmann: "Standard & Poor's Downgrade Greek Credit Rating to Junk Status". *The Guardian*, http://www.guardian.co.uk/business/2010/apr/27/greece-credit-rating-downgraded, 27 April 2010.

6 "Eurozone Approves Massive Greece Bail-out". *BBC*, http://news.bbc.co.uk/2/hi/8656649.stm, 2 May 2010.

7 *European Financial Stability Facility,* http://www.efsf.europa.eu.

8 H. McDonald: "Ireland Asks for €90bn EU Bailout". *The Guardian*, http://www.guardian.co.uk/business/2010/nov/21/ireland-asks-70bn-eu-bailout, 22 November 2010.

troubles were the outcome of its successful attempts to save Irish banks[9] for bankruptcy during the aftermath of the property bubble burst.[10] The budgetary surplus of 2007 (so before the burst) turned into the eurozone's highest deficit, reaching over 32% of GDP in 2010.[11] Unemployment naturally rose and almost trebled in the same time.[12] When it became clear that the imposed austerity measures would not succeed to turn the country's fate around, the EU agreed to reduce the interest rates of Ireland's loan and extent its maturity,[13] before actually slashing it further to 2,59%, the rate at which the EU itself borrowed the money on the financial markets.[14]

Portugal has been the third eurozone country to date to be bailed out, though not all commentators believe a bailout was necessary.[15] Compared with both Ireland and Greece, where the cause of the bailout was clearly visible, Portugal's call for help in May 2011 might have been the result of market pressure and the greedy short-sightedness of bond traders. A few weeks later Moody's cut Portugal's credit rating to "junk" status, adding further to the pressures exerted by investors and the market.[16]

Since the first Greek bailout other countries besides Portugal and Ireland have come into the focus of speculators, among others the big economies of Italy and Spain as well as Belgium. Spain has tried to strengthen investors' trust by introducing austerity measures and the German-styled debt brake into its constitution,[17] whereas Italy, in line with developments in the bailout-countries, has found itself under new leadership when Mario Monti, former European Commissioner for the Internal Market, Services, Customs and Taxation and later Competition, was sworn in as new prime minister after the resignation of Silvio Berlusconi in November 2011.[18]

9 Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life & Permanent, which owns permanent tsb, Irish Nationwide Building Society and the EBS (Educational Building Society) were rescued by the government.

10 "Irish Deficit Balloons after New Bank Bail-out". *BBC*, http://www.bbc.co.uk/news/business-11441473, 30 September 2010.

11 Data provided by ESRI: http://www.esri.ie/irish_economy/.

12 P. Halpin: "Irish Unemployment at Highest Level in 17 Years". *Reuters,* http://uk.reuters.com/article/2011/03/15/uk-ireland-economy-unemployment-idUKTRE72E4LG20110315, 15 March 2011.

13 "Ireland and Portugal Get Lower Interest Rates on Bailouts". *EUObserver,* http://euobserver.com/19/32650, 21 July 2011.

14 "Commission Proposes Better Financial Terms for EU Loans to Ireland and Portugal". *Europa,* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO%2F11%2F602&format=HTML&aged=0&language=EN&guiLanguage=en, 14 September 2011.

15 R. M. Fishman: "Portugal's Unnecessary Bailout". *New York Times,* http://www.nytimes.com/2011/04/13/opinion/13fishman.html, 12 April 2012.

16 A. Khalip: "Moody's Cuts Portugal to Junk, Warns on 2nd Bailout". *Reuters,* http://www.reuters.com/article/2011/07/05/us-portugal-ratings-moodys-idUSTRE76457020110705, 5 July 2011

17 "The Golden Amendment". *The Economist*, http://www.economist.com/node/21528317, 3 September 2011.

18 "Monti Unveils Technocratic Cabinet for Italy". *BBC,* http://www.bbc.co.uk/news/world-europe-15751179, 16 November 2011.

Pouring Good Money after Bad Money?

The European answer to the developments in the periphery of the eurozone has been fast, yet incomplete and incoherent. The creation of the European Financial Stability Faculty (EFSF) and the increase of its readily available funds to €440bn has certainly helped to rescue Greece, Ireland and Portugal, but the European war chest is too small to fend of attacks on Italy or Spain.[19] The reform programmes enacted by governments in the crisis-hit countries have delivered very mixed results. The EU has so far failed to deliver a comprehensive programme to complete the restructuring of the European periphery. Austerity alone has not been the cure and has only temporarily calmed markets. Even though there are numerous examples that IMF imposed austerity programmes without complementary mechanisms to revitalise the economy result in disastrous developments, as witnessed in Argentina in the late 1990s and early 2000s,[20] the EU has long insisted on austerity programmes and labour market reforms alone. However, these have plunged the countries into economic recession, putting further pressure on the already strained budgets of governments, as unemployment rates have soared, almost undoing any short-term savings achieved through cuts in wages and social services. Paul Krugman has recently called it the "Austerity debacle", pointing out that "expansionary austerity" has failed to deliver any of its promises.[21] Remarkably similar to the conclusion offered by Joseph Stiglitz almost ten years earlier, when he stated that: "[...] *the IMF made its fatal mistake: It encouraged a contractionary fiscal policy, the same mistake it had made in East Asia. Fiscal austerity was supposed to restore confidence. But the numbers in the IMF programme were fiction; any economist would have predicted that contractionary policies would incite slow-down, and that budget targets would not be met.*"[22]

The disappointing results of the implemented austerity measures, especially in light of the growing problems in Greece and mounting pressure on governments due to popular protest (especially in Spain and Greece), have led to a revision of the EU's insistence on austerity measures. The call for "growth-friendly consolidation and job-friendly growth"[23] marks a significant shift from the "austerity only approach" forced upon Greece, Portugal and Ireland. However, there has not been any agreement so far on how to put to life a European investment plan for these countries. There is concern that the stronger economies of the eurozone will not be willing to support any type of European "Marshall Plan" as

19 L. Elliot: "Only ECB Has Power to 'Scare' Global Stock Markets, Warns IMF". *The Guardian,* http://www.guardian.co.uk/business/2011/sep/25/ecb-power-financial-crisis-imf, 25 September 2011.

20 "Argentina Blames IMF for Crisis" *BBC,* http://news.bbc.co.uk/2/hi/americas/3941809.stm, 31 July 2004.

21 P. Krugman: "The Austerity Debacle". *New York Times,* http://www.nytimes.com/2012/01/30/opinion/krugman-the-austerity-debacle.html?_r=1, 29 January 2012.

22 J. Stiglitz: "Lessons from Argentina's Debacle". http://cdi.mecon.gov.ar/biblio/docelec/stiglitz/stiglitz4.pdf, 10 January 2002.

23 "Statement of the Members of the European Council". *Consilium Europa,* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/127599.pdf, 30 January 2012.

long as the EU lacks strong mechanisms to ensure compliance with rules and agreements – an issue just recently brought to the fore by Spain's refusal to comply with the budgetary deficit reduction targets agreed with Brussels.[24] Germany, France and the Netherlands, but also Austria and Luxembourg will be cautious to agree to any further bailouts, fearing not only the downgrading of their own credit rating (Germany, the Netherlands and Luxembourg hold AAA ratings), unless the EU can impose measures that will ensure their money is invested properly. This has been one of the reasons behind the ill-fated German calls for a budget commissioner for Greece,[25] but also the proposal made by Eurogroup chief, Jean-Claude Juncker, who demanded a "commissioner for Greece" to oversee the implementation and reconstruction of the country's economy.[26] Further proof that the more fiscally austere states of the north lack trust in Athens ability to crack down on tax evasion was delivered promptly when more than 150 German tax collectors volunteered to aid the Greek government in its struggle against tax evasion.[27]

The EFSF and the European Financial Stabilisation Mechanism (EFSM),[28] its smaller counterpart which can raise up to €60bn and uses the EU budget as collateral, are tools that currently lack the proper institutional background. Even though the EU has a central bank, namely the European Central Bank (ECB), and now employs two separate mechanisms to provide assistance to crisis-hit countries in the eurozone, both of which will be replaced by the European Stability Mechanism in 2013, it continues to lack the necessary setup to ensure fiscal prudence and economic coordination. Attempts to resolve this issue have been plenty and range from the Franco-German proposal of an economic government,[29] building upon the European Semester[30] and the EU Sixpack, and the reformed Stability and Growth Pact (SGP III), to more far-reaching proposals such as eurobonds and even a Fiscal Union.

24 J. House: "Spain Defies EU on Deficit". *Wall Street Journal,* http://online.wsj.com/article/SB10001424052970203986604577256693765874630.html, 2 March 2012.

25 "Greece Vexed by German Demand for 'Budget Commissioner'". *EUObserver,* http://euobserver.com/19/115058, 31 January 2012.

26 "Juncker Wants EU Commissioner Devoted to Greece". *Reuters,* http://www.reuters.com/article/2012/02/29/us-greece-commissoner-juncker-idUSTRE81S0PH20120229, 29 February 2012.

27 "German Tax Collectors Volunteer for Greek Duty". *The Guardian,* http://www.guardian.co.uk/business/2012/feb/27/german-tax-collectors-volunteer-greek-duty, 27 February 2012.

28 "European Financial Stabilisation Mechanism (EFSM)". *European Commission,* http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm.

29 H. Mahony: "Deal Reached on EU Economic Governance Laws". *EUObserver,* http://euobserver.com/19/113639, 15 September 2011.

30 "The European Semester: What does It Mean?". *EURactiv,* http://www.euractiv.com/euro/european-semester-what-does-it-mean-analysis-498548, 6 October 2010.

Who Could Provide Real European Leadership?

One of the biggest problems the European Union currently faces is neither caused by a lack of global demand for European goods, irresponsible governmental spending nor weak economic development in the EU itself or investors' lost trust in the common currency. The issue is fairly domestic indeed. In earlier instances of crisis, the EU had been blessed with leaders that understood the value and benefit of the European Union for their countries. Former heads of state, such as Francois Mitterrand[31] or Helmut Kohl,[32] but also Jacques Delors, as Commission President, have been able to convince their partners that more, not less, Union was necessary to overcome the obstacles the European countries faced. Major developments such as the Single Market would not have been achieved had they backed down to popular dissent. Currently neither Angela Merkel nor French president Nicolas Sarkozy seem like unwavering proponents of a closer Union.[33] Spain's prime minister Mariano Rajoy and British prime minister David Cameron fall equally short of this, in case of the former due to its short time in office and the unpopular austerity measures implemented after pressure from Spain's European partners, the latter because of the English understanding of the European Union as a primarily economic area. Currently only two politicians from the big members states come to mind that are in favour of closer coordination and cooperation and have been staunchly pro-European: Mario Monti, the appointed prime minister and head of the technocratic government in Italy and Donald Tusk, Poland's prime minister, who continues to advocate for a stronger involvement of Poland and the other new member states of the EU in shaping Europe's future. Tusk has repeatedly reiterated that not less but more Europe is the answer to solve the crisis.[34]

31 Mitterrand, first in tandem with, later in antagonism to, Kohl, defined the idea of a European Confederation again the late 1980s. Even though the project fell through less than two years later, the German–French cooperation was a major driver for further European integration. S. Hoffman: "French Dilemmas and Strategies in the New Europe". In: *After the Cold War: International Institutions and State Strategies in Europe, 1989–91* (ed. by R. Keohane, J. S. Nye, and S. Hoffmann). Harvard: Harvard University Press, 1993, pp. 127–147.

32 "World: Europe European Leaders Honour Kohl". *BBC,* http://news.bbc.co.uk/2/hi/europe/233191.stm, 11 December 1998. Helmut Kohl has been made honorary citizen of Europe, only the second person after Jean Monnet. "Helmut Kohl". *Time,* http://www.time.com/time/magazine/article/0,9171,1549800,00.html, 24 October 2006. Furthermore, both former US presidents George H. W. Bush and Bill Clinton have hailed Kohl as the greatest or most important European political leader in the second half of the last century. "Clinton Praises Germany's Kohl at Berlin Award" http://news.monstersandcritics.com/europe/news/article_1639558.php/Clinton-praises-Germany-s-Kohl-at-Berlin-award, 16 May 2011.

33 Jacques Delors, former European Commission President, has recently hinted that Merkel and Sarkozy are slowly "killing" the EU. "Delors Points the Finger at Europe's 'Killers'". *EURactiv,* http://www.euractiv.com/future-eu/delors-points-finger-europes-killers-news-511850, 29 March 2012.

34 "'Europe Is the Answer': Donald Tusk Presents Polish EU Priorities". http://www.europarl.europa.eu/news/en/headlines/content/20110627FCS22686/10/html/Europe-is-the-answer-Donald-Tusk-presents-Polish-EU-priorities, 27 June 2011; "PM Tusk – EU Must Keep Unity in Face of Crisis". *The News,* http://www.thenews.pl/9/7/Artykul/84476,PM-Tusk-EU-must-keep-unity-in-face-of-crisis, 27

Lack of Leadership and Imagination

The lack of real European leadership has fatal consequences for any attempts to strengthen the EU and make it more crisis-prone in the future. The increased use of the intergovernmental method to bring about decisions, though in line with the stronger role of the European Council and the diminished influence of the European Commission, means that the outcome of most initiatives falls short of what would be necessary to boost European integration. Agreements based on the lowest common denominator, such as the creation of the EFSF and ESM, instead of measures that would lead to more Europe might be easier to sell to the national electorates. Unfortunately such projects usually require constant adjustments. The EFSF, though a very recent result of such intergovernmental bargaining, is a good example. The initial lending capacity of €440bn might have been sufficient to bailout Greece, Ireland and Portugal, which amount to around 6% of the EU's gross domestic product (GDP).[35] However, once markets began to target Spanish and Italian bonds, concerns over the EU's ability to save one or both major economies grew rapidly. Plans to increase the lending capacity to €1 trillion, thus almost doubling the IMF/EU war chest, have been discussed repeatedly,[36] but even then a potential market attack on Spanish or Italian bonds would be difficult to fend off as both countries have combined borrowing needs of over €800bn in the next three years alone.[37] Even though European leaders agreed to increase the overall borrowing capacity of the firewall to over €800bn (more than $1.1 trillion), this can only be seen as a temporary solution. The ESM that will run parallel to the EFSF from June 2012, a year earlier than initially planned, but it will do little to resolve the underlying problems of the eurozone countries, namely a lack of competitiveness of the Portuguese and Greek economy, high unemployment, especially youth unemployment, in Spain and excessive public spending in most eurozone countries, in particular France. Neither is the ESM going to be provide adequate defences against future market attacks, as eurozone states will continue to issue national bonds that can be targeted by investors. All the ESM currently represents is a safety net for countries under distress by the markets. Its firepower is determined by the willingness of member states to contribute to it. Problems will arise once member states will follow the Finnish example and demand collaterals for their contribution[38] or will insist upon other types of securities. The current strategy thus seems to be one based on

January 2012.

35 "Report for Selected Countries and Subjects 2010". *International Monetary Fund,* http://www.imf.org/external/pubs/ft/weo/2011/01/weodata/weorept.aspx.

36 "Leaders Agree Eurozone Debt Deal after Late-Night Talks". *BBC,* http://www.bbc.co.uk/news/world-europe-15472547, 27 October 2011.

37 J. G. Neuger: "Europe Eyes Bigger IMF War Chest as Firewall Tops $1 Tril". *Bloomberg,* http://www.bloomberg.com/news/2012-03-31/europe-eyes-bigger-imf-war-chest-as-firewall-tops-1-tril.html, 31 March 2012.

38 K. Pohjanpalo: "Finland, Greece May Sign Collateral Deal in Next Few Days". *Business Week,* http://www.businessweek.com/news/2012-02-14/finland-greece-may-sign-collateral-deal-in-next-few-days.html, 14 February 2012.

hope that over €800bn will be enough to fend off any market attacks. IF not, the only solution currently envisaged is yet another increase in member state contributions to the ESM.

Incremental Intergovernmental Agreements Instead of a Bold Move Forward

There can be no doubt that Europe's leaders are not aware of the shortcomings of the current solution, but it seems that neither Merkel nor Sarkozy will dare bring forth any more far-reaching proposals that could lead to more Europe and a stronger Brussels centred solution based on a more federal model of Union. The thought of a transfer union, which factually exists if one takes into consideration the structural funds and cohesion fund distributions as well as the Common Agricultural Policy (CAP) is too closely linked to any federal model to be publicly discussed.[39] The bailouts for Greece, Ireland and Portugal are just another step into a full-fledged transfer union, a nightmare for the governments in the net contributor countries, like Germany or France, that continue to deny any such development.[40] Any official investment and redistribution programme (or coined more simply "transfer union") that would resemble Germany's *Solidarpakt* for example would immediately trigger massive protests in the richer member states of the eurozone.[41] Even though such a programme would benefit the EU in the long run a lot more than a repeated reinforcement of and increase of funds in the ESM, no active major European figure will dare bring up such an option. Chancellor Merkel, though the most imminent leader in the EU at the moment, has so far failed to take up the reins and show her European counterparts a way out of the crisis, instead preferring a policy of incremental small step solutions that require constant adjustments. Merkel's slow-paced pragmatic approach towards the crisis has triggered one of the most memorable speeches on Polish-German relations in the last decades when Poland's foreign minister Radoslaw Sikorski urged Germany to take her role as leader in Europe to save the common currency.[42] It might have helped.

39 J. McManus: "EU Transfer Union Already Here, We just don't Know It". *The Irish Times,* http://www.irishtimes.com/newspaper/finance/2011/0613/1224298810607.html, 13 June 2011.

40 C. Reiermann: "Europe on the Verge of Becoming a Transfer Union". *Spiegel,* http://www.spiegel.de/international/spiegel/0,1518,777671,00.html, 1 August 2011. As late as mid-2011, Germany's minister of economy, Philipp Rösler claimed that "The summit showed that we are not headed toward becoming a transfer union," when European leaders were trying to agree to a second Greek bailout package.

41 Germany's *Solidarpakt* (solidarity pact) was created in the aftermath of the German reunification to bring the states of the former German Democratic Republic (GDP) on the same economic level with its western counterparts. Monetary transfers till the end of 2003 were agreed upon in 1993, however, after it became apparent that the *Aufbau Ost* was going to fall short of its goal, a new *Solidarpakt II* was agreed upon in 2004. It will expire in 2019. The result is mixed so far. Cities like Dresden or Leipzig are examples of successful investments and can easily compete with any major city in western Germany. However, paradoxically, the *Solidarpakt*, though benefitting many regions in the new states forced many financially restrained cities and communities in the West to take up loans to service their contributions. This has recently led to a discussion if not a reversal, an *Aufbau West*, is necessary.

42 Q. Peel: "Germany Told to Act to Save Europe". *Financial Times,* http://www.ft.com/intl/cms/s/0/

It seems that Merkel has recently discovered her inner European and seems to articulate Germany's interest in European politics more vocally than before.[43] Not so her French partner. Nicolas Sarkozy faces presidential elections in April and May of 2012 and will thus avoid making any commitments that would see France provide even more financial support or the delegation of powers to Brussels.

The only credible commitment for a proposal of a great leap forward can be expected from the European Commission and the European Parliament. Unfortunately it seems foreseeable that the European Council will not agree to any kind of deal that will see its influence diminished. An intergovernmental agreement will almost certainly fall short of any necessary solution though. The fact that EU leaders only recently implicitly admitted that austerity measures alone were not helping neither Ireland, Portugal or Greece recover, and that austerity needed to be complemented by measures that would stimulate economic growth and the modernisation of their economies is a good example of the unfortunate lack of flexibility the European Council, and the Franco-German leadership duo in particular, has displayed. When in early March EU leaders agreed that growth stimuli are necessary or more eurozone economies might spiral into recession, they gave up a position they had viciously held onto for over a year![44]

The proposal of a fiscal pact, an intergovernmental solution, which was agreed upon by 25 of the EU's 27 member states – the UK and the Czech Republic decided to remain on the sideline instead – tackles only one side of the EU's current problems. Similar to the ESM, the "Fiscal Compact" as the new Treaty on Stability, Coordination and Governance in the Economic and Monetary Union is sometimes called, focuses on the fiscal aspect of the eurocrisis.[45] Stricter rules on the general government budget, which should be balanced or in surplus, as well as the annual structural deficit (no more than 0,5% of GDP) and a constitutional debt brake would make the Fiscal Pact a good complementary element of a more general Fiscal Union. The proposal, which envisages a greater role for the Commission and the European Court of Justice to monitor the compliance of member states in meeting their reduction targets and would give the ECJ a mandate to fine countries in breach of adopting the balanced budget rule,[46] falls short on providing any solutions to revive the struggling economies of the eurozone.

The Fiscal Compact follows the "Competitiveness Pact",[47] another Franco-German initiative that was launched in early 2011. In order to boost European competitiveness, the proposal foresaw the scrapping of the automatic indexation of wages to prices, mutual

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d29da7fc-19ee-11e1-b9d7-00144feabdc0.html#axzz1rGPxpjCc, 28 November 2011.

43 I. Traynor: "Angela Merkel Discovers Her inner European". *The Guardian,* http://www.guardian.co.uk/world/2012/jan/25/angela-merkel-discovers-inner-european, 25 January 2012.

44 "EU Wrestles with Balance between Austerity and Growth". *EURactiv,* http://www.euractiv.com/euro-finance/eu-wrestles-balance-austerity-growth-news-511237, 2 March 2012.

45 W. Boston: "EU Leaders Sign Fiscal Pact". *Wall Street Journal,* http://online.wsj.com/article/SB10001424052970203986604577256862951941608.html, 2 March 2012.

46 "The Fiscal Compact Ready to Be Signed". *European Council,* http://european-council.europa.eu/home-page/highlights/the-fiscal-compact-ready-to-be-signed-(2)?lang=en, 31 January 2012.

47 C. Brand: "Merkel, Sarkozy Outline Competitiveness Pact". *European Voice,* http://www.europeanvoice.com/article/2011/february/merkel-sarkozy-present-competitiveness-pact/70165.aspx, 4 February 2011.

recognition of diplomas and professional qualifications and a common corporate tax rate. An increase in the retirement age throughout the EU as well as further decentralisation and deregulation of wage negotiations was proposed and endorsed by all EU leaders with the notable exception of the UK, Sweden, the Czech Republic and Hungary.[48] Even though the "Pact for the Euro" or "Euro Plus Pact" (both other names given to the Competitiveness Pact) addressed the demographic issues of an ageing workforce in the EU, but growth factors are almost completely missing from it. The linkage of cheaper production costs due to decentralised wage negotiations and the scrapping of the wage indexation to prices might indeed lead to cheaper exports, however, it simultaneously will reduce the purchase power of the population. German attempts to remake the EU in her image are therefore problematic, as Germany continues to export the majority of its products to its European partners. A total shift within the EU that would see all member states amass large trade surpluses or balanced trade ratios is unrealistic and unachievable. However, this does not mean that the EU as a whole could not achieve a balanced or even positive trade balance with the rest of the world. This though would mean the EU would need to consider a structural based on the German federal state model or any other federal model.

The Fiscal Compact Lacks Its Economic Equivalent

The EU's trade balance was negative in all years since 2000 with the sole exception of 2002. In 2010 the deficit amounted to almost €160bn, down from more than €250bn just before the global financial crisis hit Europe in 2008.[49] Regardless of all statements made earlier, the EU will only be able to master the current economic crisis if it will take another step towards closer Union. This does not mean that European leaders will not continue to avoid any far-reaching agreements and will rather opt to prop up the ESM yet another time than risk a grand leap forward.

With the agreements to the Fiscal Compact and the Pact for the Euro a paradoxical situation might arise, namely that the EU will take over the responsibility to force member states to have balanced budgets under any circumstances, however, states will retain the control over any measures to achieve them. Stimulus programmes might fall short of being effective because of the new rules. Member states with less diversified economies will struggle to achieve balanced trade relations, yet diversification would require financial efforts that will be choked by the new agreements. The solution will therefore have to be on the supranational level. The cohesion and structural funds are pointing towards the future of EU involvement in member states to help them reach the goals set out in the Fiscal Compact and Pact for the Euro agreements. However, in contrast to its current role, these funds will have to be combined with a mechanism that will be used more precisely to prep up economically weak regions. The notion of a "Marshall-Plan for Greece" to kick start the Hellenic economic back to life, might illustrate the future of how EU funds

48 "Pact for the Euro. What's in a Name?". *The Economist,* http://www.economist.com/blogs/charlemagne/2011/03/pact_euro, 25 March 2011.

49 "External and Intra-EU Trade – A Statistical Yearbook – Data 1958–2010". *Eurostat,* http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-GI-11-001/EN/KS-GI-11-001-EN.PDF, 2011.

will be used in combination with cheap loan from the ECB and the European Bank for Reconstruction and Development (EBRD).[50]

Europe's leading role in the global economy is shrinking with every year and only further investment and modernisation as well as more determined efforts to boost R&D will give Europeans the chance to fend off the attacks of the rising economic super-weights in Asia and South America. The focus on high tech industries, automobile and luxury products, major drivers of Germany's economic success will be difficult to replicate elsewhere, but the EU does not lack the innovativeness and determination necessary to remain a major player and even leader in most technological and scientific areas. Companies such as Bayer (Germany), GlaxoSmithKline (UK) or Sanofi–Aventis (France) are major player in the field of pharmaceuticals and biotechnology and among the largest companies in the world in that sector. Another two companies, Hoffmann–La Roche and Novartis are based in Switzerland. Vodafone (UK), Orange (France), Telefonica (Spain) and T-Mobile (Germany) are among the world's largest mobile network operators and Volkswagen, Audi, BMW, Mercedes and Porsche among the world's most sought after automobile brands.

The EU has emerged as the global leader in the combat against climate change. Other major economies such as China or the U.S. are trailing behind, yet European efforts have been less than full-hearted and the EU is far from reaching its full renewable energy potential. Instead of embracing the so-called "green revolution" with determination, the EU has been divided between green energy slackers and green energy pioneers. Alternative energy solutions, though badly needed and advocated most vocally by the EU, play a less prominent role in Europe than other questions concerning energy efficiency and energy saving. Other European initiatives, such as the ITER (International Thermonuclear Experimental Reactor) have been repeatedly criticised and their need questioned.[51] As always after an incident of global significance, European leaders are shying away from more European commitments – the incident at the nuclear power plant in Fukushima was only the latest trigger of such notion, when member state reactions to the nuclear meltdown differed significantly with many member states accelerating their nuclear phase out, yet other announcing they would maintain or even increase the share of nuclear power in their energy mix.[52] Germany's fast track energy u-turn, the famous u-turn of the u-turn, should catapult the country into the leadership position among the biggest industrialised countries relying on green energy.[53] However (ir-)rational such a decision might have been,

50 Q. Peel: "Germans Revive Greek Marshall Plan Idea". *Financial Times,* http://www.ft.com/intl/cms/s/0/1f2ceb1e-5d51-11e1-889d-00144feabdc0.html#axzz1r1UgD0yg, 2 February 2012.

51 "MEPs Question Cash-Strapped ITER in Light of Fukushima". *EURactiv,* http://www.euractiv.com/innovation-enterprise/meps-question-cash-strapped-iter-light-fukushima-news-504193, 20 April 2011.

52 "Nuclear Phase-out can Make Germany Trailblazer – Merkel". *BBC,* http://www.bbc.co.uk/news/world-europe-13597627, 30 May 2011. Whereas Germany has announced to phase out all nuclear power plants by 2022, France has defended nuclear power as a cheap and safe source of energy. Poland, Germany's eastern neighbour, has announced plans to construct at least two nuclear power plants to diversify its energy mix.

53 P. Betts: "Germany's Nuclear U-Turn may Well Empower France". *Financial Times,* http://www.ft.com/intl/cms/s/0/d27a57fe-8d2e-11e0-bf23-00144feab49a.html#axzz1r9lLaNL7, 2 June 2011.

Germany's *Energiewende* has lost momentum in the meantime[54] and it seems unlikely that the Merkel government is going to devote much energy to it as long as the crisis is not over.

Lack of Investment in European Infrastructure, Projects and R&D

It is difficult to comprehend how the EU can one the one hand declare its ambition to remain a major player on the global economic market when at the same time it fails to make any investments in the necessary infrastructure to ensure it will not actually (literally) run out of energy. Instead of embracing the green revolution – not as a complete substitute for conventional energy sources in the near future, but as a complementary element with an increased share over the years – European leaders view renewables as a threat to the security of their countries. The notion of yet another winter that might leave parts of the EU in the cold – significantly the new member states – had given the EU's ill-fated Nabucco pipeline project a major boost. However, with a budget too small to finance the project itself, the Union faces yet again unsurmountable obstacles when member states refuse to fulfil their obligations. Neither renewables nor projects relying on fossil fuels are thus being currently supported in any manner that would increase the EU's overall energy security – an issue that is further increased by the lack of investment in cross-border energy corridors.[55]

The EU is in need of a solution that will help finance and push through projects that will ensure its competitiveness and (energy) security in the future. The current arrangements that see member states contribute a little more than 1% of their GNP (Gross National Product) to the EU budget is no longer viable when taking into account the future financial needs to beef up weaker economies and increase their competitiveness. The question therefore remains how the EU will be able to increase the size of its coffers without putting more pressure on national budgets. Ideas such as the Tobin tax (or similar financial transaction taxes) might be a good starting point, however in the long term the solution will probably have to involve a further transfer of sovereignty to Brussels. As more research and development projects will have to be solved on a supranational level due to increased costs and the need for shared financing, it would seem plausible to ensure the EU develops mechanisms to ensure the stable financing of projects of European interest.

The current economic downturn in the countries of the periphery, combined with their liquidity problems and the uncertain future of the EU as a global economic leader and

54 A. Neubacher: "Verblende". *Spiegel,* http://www.spiegel.de/spiegel/print/d-83588339.html, 16 January 2012. In particular the German obsession with solar energy with very high subsidies for users of photovoltaic panels has been highlighted as an obstacle to a real transition to green energy. Investments in energy transmission infrastructure has been postponed or abandoned whilst more than 8bn euro have been paid in subsidies. The result is a meagre 3 per cent share of photovoltaics in Germany's electricity generation.

55 S. van Renssen: "Financial Barriers to Cross-Border Energy". *European Voice,* http://www.europeanvoice.com/folder/energyinfrastructure/203.aspx?artid=73609, 16 February 2012.

pioneer in science make it necessary to develop ways to ensure a stable and sustainable development plan for the next two or three decades and beyond. Given the current situation, and the risk of the possible contagion of the eurocrisis to affect either Italy or Spain (or in the worst case scenario both), will force Europe into decisions that will have to be more far reaching than the current Pacts on stability or fiscal prudence.

In the long run it seems very likely that some kind of fiscal Union will emerge. In how far this type of Union will give the EU additional taxation rights is not clear, however, a much larger EU budget will be a sure outcome of such an agreement. Two scenarios seem possible: a) a dramatic worsening of the current eurozone crisis that forces the EU to take a grand leap forward, or b) a persistent eurozone crisis that only very gradually weakens. Regardless of which scenario the EU will have to endure, the outcome in both cases will be a closer Union with more competences and a stronger federal structure, probably based on the German model of federalism. The degree of how fast such a process will take place and how much sovereignty is going to be transferred to Brussels will to a large extent depend on how hard the eurozone is hit by the crisis. Based on the assumption that a more severe crisis will be more likely to trigger faster and more far-reaching agreements, a dramatic rise of yields of Spanish and Italian bonds would result in commitments going beyond repeated financial injections into the EFSF and ESM. A similar conclusion can be drawn to a large extent should Portugal require a second bailout or Ireland fail to return to robust growth by mid-2013. Two other outcomes of the crisis are possible but highly unlikely and will therefore not be elaborated on, namely c) despite a continued threat of contagion and default, the present European answer of an increased firewall and the pacts is enough to ensure the EU is able to largely preserve a status quo and d) the crisis proves too big for the EU which fails to stand together in the face of such threat. Nationalisms prevail over European support, triggering the slow (or rapid) death of the European project. Even though the EU might lack leadership of real devoted Europhile leaders, the last scenario can almost certainly be excluded from any further analysis.

It is difficult to predict the future development of the eurocrisis, as there is no agreement yet on whether the crisis might not be over. Whereas some, like ECB chief Mario Draghi say the worst is over,[56] others like ECB policymaker Marko Kranjec disagree.[57] Given the current economic outlook, doubts over the future ability of Portugal to survive without a second bailout and severe concern over the state of the Spanish economy and slow growth rates in most other eurozone economies are giving little reason for optimism. Even though the European Commission has praised Portugal's efforts to reduce its deficit and implement austerity measures, going so far as to state that "Overall, the programme is on track. The fiscal adjustment in 2011-2012 is remarkable by any standards",[58] high unemployment rates and very meagre growth prospects for 2013 could force the country into requesting a second bailout. In the worst case, as described by Mohamed El-Erian,

56 "ECB Chief Mario Draghi Says Worst of Euro Crisis over". *BBC*, http://www.bbc.co.uk/news/business-17471617, 22 March 2012.

57 M. Novak: "ECB's Kranjec Says Not Sure Euro Crisis over: Paper". *Reuters,* http://www.reuters.com/article/2012/03/30/us-ecb-kranjec-idUSBRE82T15S20120330, 30 March 2012.

58 A. Khalip: "Portugal Reforms on Track, no Second Bailout – EU". *Reuters,* http://uk.reuters.com/article/2012/04/03/uk-eu-portugal-idUKBRE8320CB20120403 3 April 2012.

chief executive of the world's largest bond investor, PIMCO LLC, Portugal will need a second bailout and might even follow Athens and default on its debt.[59]

Using the worsening economic indicators as a precursor to a continuation and worsening of the crisis, the most likely country to be sucked into the downward spiral would be Spain. Its banking sector has not yet recovered from the housing and construction bubble and doubts remain if a consolidation of the bloated banking market is going to be enough to keep the system from collapsing.[60] Should Spain's banking sector collapse or unemployment figures continue to rise and the country's economy slide further into recession, or should the government prove unable to convince markets that it is able to deliver the necessary reform, then Madrid might be next in need of financial support provided by its European partners and the IMF.[61]

Regardless of the current "Monti-effect"[62] and the so far very successful efforts of the technocratic government in Italy to reduce the country's deficit and measures to revive the dormant economy, it seems like the most plausible scenario that Spain would drag Italy with it if markets succeed to force Madrid to request a bailout. However, not only bond markets prices should worry the Italian government as its approval rating is dropping after it announced a series of tough measures to make the Italian economy more flexible.[63] Should this scenario occur, then a simple leveraging of the ESM will not be enough to fend off market attacks. A more far-reaching solution will be necessary that will allow the EU to prop up Spain's banking system and kick start both economies into productivity.

A more extensive and certainly costlier effort to modernise the southern economies can only be achieved by stronger contributions from the northern economies of the Union. As neither Paris, nor Berlin or the Benelux or Nordic countries will agree to such an arrangement without being given stronger means to control how their money is invested, the EU will have to establish a mechanism that will allow it to work directly with and if necessary without the respective ministries of economy, labour and finance in the affected countries. The latter case would be triggered if a country fails to implement measures agreed upon in return for financial aid from the EU and would have a temporarily limited

59 P. Inman: "Portugal will Be the Next Greece, Predicts Mohamed El-Erian". *The Guardian,* http://www.guardian.co.uk/business/2012/mar/18/portugal-next-greece-mohamed-el-erian, 18 March 2012.

60 M. Johnson: "S&P Turns on Spain's Banking Sector". *Financial Times,* http://www.ft.com/intl/cms/s/0/7cc86d44-5684-11e1-a328-00144feabdc0.html#axzz1r9lLaNL7, 13 February 2012.

61 A. Benoit: "Spain's Economic Woes Rattle Investors; Europe Markets Slide". *Bloomberg,* http://www.bloomberg.com/news/2012-04-05/spanish-economic-woes-rattle-investors-as-european-markets-slide.html, 5 April 2012.

62 H. Mahony: "Summit Footnote – the 'Monti Effect'". *EUObserver,* http://blogs.euobserver.com/mahony/2012/03/08/summit-footnote-the-monti-effect/, 8 March 2012.

63 R. Donadio: "Italy's Prime Minister Shifts Recovery Focus to Economic Growth'. *New York Times,* http://www.nytimes.com/2012/01/10/world/europe/mario-monti-shifts-emphasis-in-italy-to-growth.html?_r=1, 9 January 2012. It clearly seems that the Italian population was willing to accept reforms in the pension structure and the implementation of austerity measures, but addressing the rigid and very inflexible labour market rules, including the many professional guilds and labour unions, has caused uproar and will see the country's largest labour unions march jointly in protest against the Monti government. See also: B. Moody: "Analysis: Storm Clouds Gather over Monti's Italy Reform Drive". *Reuters*, http://www.reuters.com/article/2012/03/30/us-italy-monti-idUSBRE82T19820120330, 30 March 2012.

time frame. Based on the experiences made with the Monti government in Italy which took decisions no established party in the country would have dared implement due to fear of electoral backlash, a technocratic interim government approach might be necessary to ensure compliance with Commission and Council approved programmes. The idea of a "reconstruction commissioner" might be a crude illustration of such an interim solution.[64] In such a case the current positions of the commissioners for Economic and Monetary Affairs and the Euro and Competition would necessarily have to be empowered and would form together with their colleagues of the departments for Regional Policy and Internal Market and Service the "inner college" of commissioners responsible for the revitalisation of the European economy and the coordinated modernisation of less competitive member states.

EU Bonds to Finance European Investments in Infrastructure and Modernisation Efforts

In order to finance such expenditures the EU will have to develop new mechanisms that will allow it to raise large amounts of money without putting a too heavy burden on member states. Given its impeccable reputation and the so far unwavering trust of the markets in the overall ability of the EU to maintain a dominant economic role in the future,[65] one solution could be the creation of EU bonds issued specifically for the purpose of boosting the EU coffers. These "modernisation bonds" would be backed by the EU's budget as collateral. With a medium maturity of ten years, this solution would give the EU enough time to see its efforts pay off and result in stronger competitiveness as a whole. Whether these bonds would be issued jointly by all EU member states or only the countries of the eurozone and separately for the non-euro countries would have to be determined by Europe's leaders.

Proposals such as "elite bonds", issued jointly by eurozone countries with a AAA rating but used to prop up the economy of the EU27 would be another possible solution, though less likely given the reluctance and the risk of moral hazard.[66] However, following the latest downgrades of France and Austria, two of the targeted triple A rated countries, the elite bond solution would currently consist only of Germany, Finland, Luxembourg as well as the Netherlands.[67]

64 "Juncker Wants 'Reconstruction Commissioner' for Greece". *EUObserver,* http://euobserver.com/19/115434, 29 February 2012.

65 M. Deen: "France Joins Spain to Defy Moody's Downgrade with $18.5 Billion Bond Sales". *Bloomberg,* http://www.bloomberg.com/news/2012-02-15/france-joins-spain-to-defy-moody-s-with-14-3-billion-euro-debt-sale-plan.html, 16 February 2012. Despite being downgraded just days earlier by U.S. Ratings agency Moody's, France and Spain successfully issued their latest round of bond sales, with overall demand exceeding the offered debt. Whereas French yields have fallen since the downgrade to AA by S&P in January, Spanish yields have risen only moderately.

66 "Report: Germany Wants 'Elite' Bonds for Six Euro-Countries". *EUObserver,* http://euobserver.com/19/114408, 28 November 2011.

67 G. Wiesmann: "S&P Downgrades France and Austria". *Financial Times,* http://www.ft.com/cms/s/0/78bf6fb4-3df6-11e1-91f3-00144feabdc0.html#axzz1rGPxpjCc, 14 January 2012. The fact that 14

The suggested creation of blue bonds, as opposed to the currently used red bonds, i.e. traditional national government issued bonds, by Brussels-based think-tank Bruegel, deserves consideration.[68] The proposal details that every eurozone state would pool a certain amount of national GDP debt, for example 60%, into EU blue bonds, and only debt above that level would be issued as regular red bonds. These red bonds would remain separated from the blue bonds and would have an independent mechanism for the unlikely case of a potential default. These jointly issued bonds of all current eurozone countries would help bring down overall borrowing costs, even for those countries most affected by the galloping rise of their yields. The creation of blue bonds would have to be complemented by the creation of an Independent Stability Council that would annually determine how many blue bonds would be issued to ensure financial stability. Two issues would have to be addressed, however, before blue bonds can be created: Moral hazard and free riders. Only if the better rated and richer member states will receive guarantees that moral hazard and free riders, namely the deliberate and (un-)conscious decision of weaker economies to rely simply on the good rating of the blue bonds and the warranted knowledge that in case of partial default an EU bailout mechanism would be triggered, can be contained, will this proposal have any realistic chance to be realised. Currently Germany still opposed any kind of Eurobonds, and both the Netherlands and Austria, and most likely the majority of the stronger eurozone countries, might share the position that Eurobonds will put too much pressure on better off countries. However, should the initial proposal find any support, it might significantly lower the interest rates for most member states during bond auctions. Four countries of the Eurozone would presently not issue any red bonds if the eurobond solution was implemented: Finland, Slovakia, Luxembourg and Slovenia all have GDP debt levels below 60%, and another six (Cyprus, the Netherlands, Malta, Spain, Austria and Germany) would issue red bonds for no more than 20% of GDP debt.[69] Even though red bond prices would carry a higher premium, offering another reason for their respective governments to implement programmes to reduce debt.

A Brief Summary

Given the eurozone's currently fragile composition of one undisputed economic powerhouse, a few economic heavyweights with worrisome deficit and GDP debt levels and a periphery that struggles to return to economic growth after the implementation of IMF/EU austerity programmes, another bond shock might prove too much for the current financial firewall, the ESM. As the outcome or even the current

out of 16 countries in the eurozone were given a negative outlook, including France, Spain and Italy, meaning further downgrades within a year are very likely, does not exactly leave much room for optimism that the elite bond solution will consist of a substantial share of the eurozone's strongest economies.

68 J. von Weizsäcker – J. Delpha: "The Blue Bond Proposal". *Bruegel,* http://www.bruegel.org/download/parent/403-the-blue-bond-proposal/file/885-the-blue-bond-proposal-english/, 6 March 2012.

69 "General Government Gross Debt, 2010". *Eurostat,* http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=0&language=en&pcode=teina225.

state of the eurozone crisis is unclear, European leaders find themselves in a limbo. Assuming the recent boost of the ESM is enough to calm markets, the creation of it and the agreements to enforce the Competitiveness Pact and the Pact for the Euro, might represent the final developments towards closer economic and fiscal Union. However, structural problems in many eurozone countries and especially Spain and Italy warrant the assumption that the worst is yet to come and with it a radical make-up of the EU. Stronger efforts to return the EU economy to growth will require means to raise money more effectively at lower interest rates and without putting too much pressure on member state budgets. A type of jointly issued bonds – here called "modernisation bonds" for simplicity – could represent such a solution but would probably be complemented by more types of EU bonds, potentially based on the blue and red bond suggestion brought forward by economist Jakob von Weizsäcker. A further move towards a transfer union and more federalism will be accelerated by the worsening of the crisis. The creation of emergency "reconstruction" commissioners and a more prominent role of certain commissioners in the European Commission in an "inner college for economic development and modernisation" would be a necessary consequence of supplementing the current approaches of European leaders to implement austerity and fiscal prudence in the EU with mechanisms that will allow the EU to play a more proactive role in fostering development and modernisation of economically backward and underdeveloped regions.