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CEPS Policy Brief

Thinking ahead for Europe

CENTRE FOR EUROPEAN POLICY STUDIES

No. 217/November 2010

The European Council Summit and the Political Economics of the EMU Crisis

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Roger Ailes, a former advisor to Ronald Reagan, recalls in his book an intriguing practice of the ancient Romans: when they finished building a bridge or an arch, they enforced accountability by placing the engineer in charge beneath the construction when the scaffolding was removed. If the edifice did not hold, he was the first to know. We do not follow such drastic practices these days in Europe, but with some European economies shaking and the Greek sovereign debt crisis still not over, the architecture of the euro area has been certainly come under severe stress. Unfortunately, the 28-29 October 2010 European Council Summit has not made this architecture much safer.

What has been agreed upon in Brussels? The European heads of state and governments mandated Herman Van Rompuy, the EU's permanent President, and the European Commission to conduct further inspections of the euro area economic governance. However, the reading of the summit's conclusions suggest that forthcoming consultations with the member states should primarily focus on designing a "permanent crisis mechanism" to safeguard the euro area as a whole. In this respect, the 'no bail-out' clause in Art. 125 TFEU will most probably not be touched but rather annulled by a re-interpretation of Art. 122 TFEU. That is, the threats to the stability of the euro area as a whole will be interpreted as an "exceptional occurrence" beyond a member state's control, thereby justifying bail-outs. Such changes to the Treaty most probably only require secondary legislation, which can be implemented without a referendum in the member states. The reason for calling for such treaty changes pertains to some member states' fear – in particular in Germany – that certain provisions of the current discretionary scheme will not sustain judicial review in national courts.

What's the backdrop of the Summit? The European Council was intended to address the challenges posed by very recent events. Just some months ago, in an immediate reaction to the deteriorated market sentiments towards the euro, the EU put together two comprehensive stabilisation programmes, one for Greece worth €110 billion, and one for the whole euro area, the so-called European Stabilisation Programme, worth €750 billion. Both support packages have been approved despite being hugely controversial among economists and policy-makers. This was the right decision to take on such short notice, but long-term challenges remain that need to be addressed by overhauling EMU's economic governance.

Looking at the Brussels summit from this perspective, making the bail-out mechanism rules-based and explicit would in principle be a step in the right direction. However, the provisions of a permanent crisis mechanism seemingly agreed at the Summit are by far not satisfactory. Such a mechanism should be guarded by a high degree of accountability and strong

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constraints on fiscal profligacy at the political level, for example, by establishing 'exit rules'.

Why? Early worries about the negative consequences of the EU bail-out aired by some commentators and policy-makers were largely overblown. When the EU took action, an oft-heard assessment was and still seems to be among many economists that i) the bail-out was a mistake, ii) the political haggling over it was irrational and iii) the bail-out would create a moral hazard problem. Contrary to these warnings, however, we have recently shown that given EMU's present political-economic set-up, i) the bail-out was unavoidable, ii) the lengthy process of political haggling leading to it was understandable, and iii) a bail-out does not have to necessarily be associated with a future moral hazard problem. Our analysis has been based on a model that allows us to understand why and how the parties involved in the Greek crisis arrived at the bail-out and on what conditions the final solution depends. Importantly, we have formally taken account of the 'negative externality' problem that has been central to policy debates related to the EMU's institutional design since the very birth of the euro (see, for example, Gros et al., 2005). This externality also played an important role in the specific case of the Greek crisis, with some commentators even calling it a 'bail-out blackmail' (see Mayer, 2010). Contrary to the existing literature, however, we have not only focused on the economic aspect of such a negative externality, but also looked at how it emanates and interact with the political factors, in particular the dynamics of the political negotiation process within the EU.

The major factor that explains the difference between our results and the contrasting results of other commentators is that our analysis has been conditioned upon the present political-economic set-up of the EMU. This seems crucial in the EU context, since the Greek crisis – as practically all other EU affairs – involved intense negotiations among the member countries and depended to a large extent on political factors. An analysis that does not take account of these interactions between the economic and political factors must be incomplete as it abstracts from a very important part of EU reality. After all, the EMU problems do not only ensue from the Greek and other European countries' fiscal problems alone, but from the interactions of these problems with the actual political-economic configuration of the EMU. The sheer fact that countries share the same currency does not necessarily have to lead to negative spillovers between them. As Balcerowicz (2010) rightly points out, if this was the case, the fiscal problems in Ecuador, a dollarized country, would give rise to a threat to the dollar – evidently this is not the case. In the EMU, however, refinancing difficulties of a small country like Greece, which accounts for only 2% of the euro area's GDP, can trigger a systemic crisis for the whole EMU. This is different from the case of the US monetary union where fiscal woes of even such big states as California do not wreak such havoc.

The weakness of the current EMU governance is that it neither provides sufficient incentives for curtailing excessive lending and indebtedness (for more, see de Haan et al., 2004), nor secures the level of political integration necessary to attain a sufficient degree of accountability in fiscal affairs. Strengthening fiscal prudence is of utmost importance, but it has consistently collided with the enforceability problem of applying supra-national fiscal rules to sovereign member states. The current architecture of EMU does not carry. While stepping-up the degree of political integration could alleviate this tension, policy-makers in Europe are well aware of how lengthy this process would be and how naïve it is to believe that political integration could be significantly accelerated.

Squeezed between the undesirable now and the far-off future, EMU needs to develop some intermediate solutions that would help to bridge this gap. Two possible avenues include the following solutions.

First, should a bail-out be unavoidable, given the current state of the political-economic configuration of the EMU – as our analysis suggests – it is better to make it rule-based and explicit. This may at least limit the haggling and uncertainty in the course of such events resulting in a lower risk premium associated with such uncertainty (see Bini Smaghi, 2010, who makes a similar case in the context of financial markets). In this respect, our analysis lends support to the incipient discussion of sovereign bankruptcy (Financial Times, 2010) and earlier proposals for a European Monetary Fund suggested by Gros & Mayer (2010). However, any form of legal sovereign insolvency rules has to reinstate the cost-by-cause principle in European fiscal affairs by bringing accountability back to the member state level.

Therefore, second, to improve EMU's functioning, more weight should be given to solutions that address the issue of negative externality on a political level and not only an economic one. One way to approach this could be to change political incentives in the negotiation processes of the EMU. In a sense, this would address the political aspect of the political-economic set-up of the EMU and hence would complement the necessary (but so far largely failed) efforts to improve the EU and domestic fiscal frameworks per se. One such solution could be to establish 'exit rules'. Specifying conditions for leaving the EMU, including the costs and legal requirements of such an operation, would work at least through three channels:

i) On the constituency level, it would make exit costs explicit to electorates, thus diminishing tendencies to fiscal bias.

ii) On the government level, it would weaken the bargaining position of troubled countries vis-à-vis the rest of EU-member countries – concomitantly reducing Mayer's 'blackmail' practices in terms of deliberately using the negative externality risk to elicit fiscal redistribution from other members.

iii) On the markets level, it would reduce uncertainty and stabilise market reaction in case of a future potential default or exit, thus decreasing the scope for a negative externality.

Overall, making exit costs and procedures explicit would increase the perceived costs of a legally possible exit relative to the short-term political costs of economic adjustment. This would serve as a deterrent to brinkmanship, stimulate fiscal discipline and decrease the scope of the inherent negative externality problem within the euro area. While additional research is needed to shed more light on the political economics of crafting such exit rules, it seems that the existence of the rules would strengthen accountability in fiscal affairs and sustainability of the euro area in the long-run. Paradoxically, it may make future exits less – not more – probable, as shown by the history of certain national states struggling to preserve their internal integration (see Economist, 2005). Their experience suggests that when secession is not permitted, a pressure for it rises. When secession is openly allowed, many would-be secessionists cease to press so hard for it – or for a bail-out, as is the case with the Greek-type crisis.

Just before the euro was launched, Bordo & Jonung (1999) highlighted in an extensive study of historical monetary unions that political factors had been always the key determinants of their success or failure. Recent EMU experience clearly approves of this message. While most economists agree on this point, when it comes to designing reform proposals we tend to focus mainly on economic solutions, whereas political incentives are usually taken as given. This may be a mistake. After all, EMU is as much a political as an economic project. Including both dimensions in a policy analysis may lead to a better policy design and make the euro-area architecture safer. In this respect, accountability is not achieved by the mere provision of a permanent bail-out facility. This may possibly even erode the foundations of the architecture in terms of deteriorating public approval toward Europe in some member states. It's symbolic that euro banknotes feature bridges and arches – perhaps also an omen.

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