

European issues

n°215

3<sup>rd</sup> October 2011

# The Euro and the Debt Crisis: towards greater political integration

By **Alain Fabre**

Economist, Financial Consultant

**ABSTRACT**

In spite of the means deployed since the beginning of the crisis, the euro zone is still under pressure from the financial markets. The latter fear that differing opinions which continue to rage over the method to employ to solve the crisis will finally lead to the infection of all euro zone States and the banking systems, which have already suffered the effects of the financial turbulence of 2008-2009. Europeans are struggling to draw the lessons of the failure of the Stability and Growth Pact, which enabled the establishment of diverging economic policies. The euro zone debt crisis requires a high level of integration in terms of budgetary policy and greater progress towards the building of real budgetary federalism on a community level; total financial solidarity should help to dispel illusions about transferring, even the partial payment of Greece's debt to the banks, which leads to risks regarding levels of aid to the economy. Finally Europeans must stop believing in growth strategies that are of an artificial, dangerous nature, based on consumption and excessive debt. Austerity plans, which are now becoming the norm, must herald the start of growth strategies based on the control of public finances and business competitiveness. This is how Europe will strengthen its social model in a globalising world. However Europeans have managed to define correctly targeted responses, which were impossible before the crisis. Europe's progress towards a more integrated, more federal political structure is probably the best answer to give to those who lament the decline of national sovereignty. This supposes courage and the provision of a political dimension to the work started, since this process will necessarily be part of the long term.

One might have thought that with the financial clout, totalling 750 billion €, deployed by the Europeans and the IMF, notably in May 2010, together with the creation of the European Financial Stability Fund (EFSF), to a total of 440 billion €, that the euro zone would have found the means to solve Greece's debt situation and to stabilise the financial markets. However this has come to nought and the Greek rescue plans, such as the one announced on 21st July last, far from calming matters, seem to have fed investors' feverishness and defiance. There is a growing feeling that all the declarations made are merely means of putting vital issues off until later and that Europeans are only able to conclude superficial agreements to relieve the pain and not the treat the disease itself. By dint of prevarication – too little, too late – there is a growing danger that the Greek debt crisis, which the euro zone Member States could easily pay, will finally turn into a major European banking

crisis with all the risks this entails for international financial stability. Doubts are starting to grow about the euro zone States' ability to apply the budgetary austerity programmes that have often hastily been announced and for them to bear the financial commitments required by the bank rescue plans of 2008.

**1. Lessons of the Crisis**

At this stage in its development three facets have come to light in the euro zone crisis.

***Managing the euro differently***

The first of these is the inability of euro zone governments to learn fully from the failure of the Stability and Growth Pact and to come up with other ways of managing the single currency. Europeans, with Germany in the lead, wanted to believe that the euro zone could adapt to the upkeep of autonomous budgetary policies and that pressure would be sufficiently high on States to point na-

tional policies towards rigour, thereby ipso facto guaranteeing convergence, and even integration. The no bail-out clause was assimilated to budgetary rigour and attempted to substitute all forms of national budget pooling strategies. Of course the Germans are undertaking the right budgetary policy but the no-bail out clause is not giving any incentive for rigour amongst its partners using the same currency. On the contrary, since the euro offered lower interest rates than those that would have been applied to national currencies, there was greater room to manoeuvre for the governments who tended the most towards accommodating budgetary policies, which the most poverty-stricken were quick to make the most of. As it required States to implement recovery plans and aid to distressed banks in the wake of financial implosion in 2008-2009, the crisis revealed these basic contradictions. Moreover its depressive effects revealed the cumulative risks of the recession and of excessive debts on the most vulnerable economies and also on the stability of the zone.

#### **Vital Financial Solidarity**

The second aspect of the crisis that Europeans refuse to accept, is the financial solidarity that results from sharing the same currency. One of the main consequences of the creation of the euro was that one person's debt was then shared by everyone else. It is because of this fundamental feature that for the most part, differences in rates were tightened as they were before the crisis. In other words the States which agreed to share the same currency established, in spite of any of the official denials, the possibility for each and every one of them to pilot the others' budgetary policy. Hence if we express this in a deliberately provocative way, but which reflects the truth behind the fundamental mechanisms of a single currency, the fact that Germany accepted Greece into the euro meant that the Greek government could raise taxes from the taxpayer in Hamburg. This is the reason which basically justifies, not the coordination, but the integration of budgetary policy on a community level. It is precisely because the Austrian or Dutch taxpayer may in fine have to pay the salaries of Spanish civil servants or come to the aid of the Irish Treasury that budgetary policies have to lose their autonomy, either on the first euro spent, or when certain thresholds, which of course are always arbitrary in part, are surpassed: a deficit higher than 3% of the GDP, debt over 60% of the GDP. The governments and public opinion of the most "virtuous" countries may, quite rightly, find the way that "lax" governments have managed

their public finances appalling, but to avoid this terrible situation, the terms of mutual policy surveillance should have been established on the introduction of the single currency.

The lesson to be learnt from this is that government securities issued by one of the States absolutely have to remain safe, otherwise the banking system finds itself under pressure, and attempts to find part compensation for prudential ratio adjustments by contracting aid to the economy. Of course the Germans quite rightly complain of the disgraceful behaviour by some governments, including Athens, but since the German economy achieves half of its trade surplus in Europe, due to the competitiveness of its prices, thanks to the euro it benefits from a kind of subsidy, which is underestimated against an implicit deutschemark. Nothing would be worse than if Greece were to succumb to an Argentinean like bankruptcy, which would threaten to infect the entire euro zone; Germany would not be spared since its de facto commitments to stabilise the zone or to save threatened banks would come in addition to a level of debt that is, all in all, quite high too (84% of the GDP, 2079 billion €, levels that are higher than France and Italy), against growth in 2012 that will be halved in comparison with the present rate (+1.3% after 2.7% in 2011). Moreover, after having cultivated the illusion of spontaneously virtuous policies, simply because they are said to fall in line with the Stability and Growth Pact, the German government, by demanding – due to the weakness of the CDU/CSU-FDP coalition – that part of the losses caused by the Greek debt, should be integrated into the banks' balance sheets, has run the risk of weakening the entire system. Quite clearly this is a deliberately self-destructive policy. Forcing European banks to integrate into their balance sheet some of the losses of the Greek debt, running the risk of launching rumours about Spain, Italian and others, whilst they are still recovering from financial turbulence, implies an incredible, particularly dangerous, risk. This is because an escalation in the situation would probably require further state intervention in support to the banks and at the same time run the risk of forcing them into reducing aid to the economy. It is impossible to understand why three years ago it was absolutely necessary – in the name of the Irving Fisher theory[1] and the example of the 19030's crisis – to rescue the banks at all costs, and why now, simply because they believe that by subscribing to government bonds, holding safe securities and trusting the signature of the euro zone States, they would find themselves in a vulnerable situation. It is difficult to see

1. In 1933 in a famous article "Debt Deflation", Irving Fisher highlighted the cumulative, depressive effects of excessive debt and deflation. In a market that lacks liquidities, the sales of bonds leads to an increase in the real value of the debt. This directly affects the banking system which accelerates deflation by the contraction money supplies to the economy. It was on the Fisher theory that the States justified the banks' rescue plans in 2008-2009.

how we would make the German taxpayer happy by transferring part of the Greek debt into the banks' balance sheets and then to convince him immediately afterwards that he should support the Federal State's intervention in favour of the Commerzbank or the Deutsche Bank, and via the EFSF provide help to other credit establishments in the euro zone.

It is a fact that the Greek State is bankrupt. It probably cannot repay more than half of the 450 billion of its public debt, and unless it has the payment of 8 billion € in October, it will be impossible to pay civil servants' salaries. However if there are losses and restructuring has to occur, then this must be taken on directly by the euro zone Member States. This is one of the most effective ways of settling bankrupt Greece's financial situation without bringing down Europe as a whole and the best support that States can give to their banking system affected by the sovereign debt. In order to prevent Greece finding itself in an unrealistic situation, in which austerity measures make all attempts to discharge the debt impossible – which now totals nearly 160% of the GDP, the roles of the "Troika" representatives (European Central Bank, IMF, Commission) would be to calculate the weight of the debt, bearable by Greece on the basis of austerity plans and potential growth rates mid-term – probably between half and two thirds. Everything over this amount would be transferred to the EFSF and exchanged, without making any losses, by investors against securities issued by the EFSF. Europeans would be able to decide on the share of the debt that could be spread over time, even if this was over several decades or more. The Greek debt has to be organised with the euro zone States and not, even in part, by undermining the banking system.

### ***Budgetary rigour, a condition for European competitiveness.***

The third facet of the present crisis is that the austerity policies that are now widespread across Europe and not only in the euro area, have to make sense, as illustrated by the programme to reduce spending adopted by the British government to a total of £84 billion and which aims to achieve balance by 2015-2016. One of the vital lessons to be learned of the 2008-2009 crisis, like the one that followed in the euro zone, is that of the end of economic strategies based on the artificial stimulation of growth and consumption via debt and of their illusionary, counterproductive nature. The German example shows that in this time of globalisation,

the winning strategy, notably when it comes to defending the European model of social protection, is one which is based on giving priority economic competitiveness. Budgetary rigour, far from being in conflict with this goal, becomes a condition of it. Long term strategies based on wage reductions and financial accumulation in businesses balance sheets have proven to be the best ways to absorb the effects of the crisis and to avoid the rise in unemployment. In all events even though a State might count on the short term solidarity of its partners, it can only recover its long term capacity to re-establish economic growth and its ability to pay off its debts by developing a healthy, competitive productive system. Moreover if we find ourselves in a Keynesian situation, as was the case after the collapse of Lehman Brothers in September 2008, rising to challenges like this is more effective if the public balance is positive as in Germany (+0.1% of the GDP in 2008, -3.3% in 2010) than when there is permanent deficit, as in France (-3.3% of the GDP in 2008, -7% in 2010).

The Irish example shows that the implementation of European solidarity together with an approved austerity policy creates the conditions required for growth (+1,6% in the second quarter), notably thanks to exports (+25%). Conversely doubts about European financial solidarity and delays in implementing Greek recovery measures (privatisations, reductions in spending) have fed the self-fulfilling scenario of bankruptcy and depression. The weakness of the system is also worsened by the prevarication of countries like Italy (a debt of 1,900 billion €) and France which restricts itself to minimal adjustment declarations (11 billion € when the effort required to bring its deficit down to 3% of the GDP is due to total 120 billion € over four years). Adjustment focuses almost exclusively on taxing the "wealthy" and barely touches on reductions in spending (1 billion € in the French plan announced at the end of August out of 1045 billion € in public spending). The USA's loss of its AAA status in the summer and the downgrading of the Italian rating shows that these illusory policies are not enough to hoodwink either the investors nor to recover a competitive growth strategy. And how might we succeed in preparing community financial reform if only Germany, amongst the major euro zone countries, finds itself with an AAA rating?

### **2. Towards building a integrated, federal policy**

The governments in the euro zone must commit

unquestioningly to in depth change, because the internal euro zone crisis is mainly being paid by the Europeans and also because the markets tell us clearly that declarations that are restricted to public relations exercises, often for domestic purposes, or minor reforms that are limited to containment, will no longer be enough to satisfy worried investors.

#### ***The Limits of National Solutions***

Europe is capable of solving this crisis, whilst juxtaposing national solutions feeds uncertainty and struggles to find the means. Moreover if euro zone States are considered together, they are in a much less perilous situation than the USA and Japan. In 2010, Europeans recorded a deficit of 6% of their GDP and a debt level of 85.4% whilst the USA had a deficit of 11.2% and a debt level of 92%. As for Japan, these rates total 9.5% and 220% respectively. In addition to this the UK, a non-euro zone member, recorded a deficit of 11.2% and a debt level of 80%. These data show that the euro zone is in a situation – if considered from a “federal” point of view – in which it can easily deal with the budgetary problems of distressed States. But the risks facing the entire system and each member state are increased, if on the contrary, the federal dimension of solutions is limited to a strict minimum and if we continue to privilege national measures.

Since Europe shows that is unable to solve problems of which it is in fact capable, it lays itself open to critics, rightly or wrongly, in the light of the situation in the USA, who accuse it of feeding the vulnerability of international financial systems. By opting for federal solutions, via the guarantee to investors that securities issued by euro zone States cannot possibly default and by feeding the markets with “federal” euro zone securities, Europe would strengthen its international position, and, at the same time, it would trigger off stabilising effects within the euro zone – thereby fostering the birth of budgetary federalism. Since Europe is not an optimal monetary zone in which the labour market is fluid – unemployed Spaniards do not go to Germany to find work – only budgetary transfers enable the compensation of imbalance in a non-optimal monetary zone, since adjustments via exchange rates cannot occur in the single currency.

#### ***Real Progress Towards Economic Federalism***

Even if matters are still in an embryonic state, Europe has nevertheless managed to make changes that seemed unattainable before the crisis. The

myth of coordinating budgetary policy – some boost whilst others adopt austerity – has been relinquished to the profit of an approach that is clearly oriented towards federalism and budgetary integration. From this standpoint we can re-analyse the divergences observed in terms of European economies during the 2000’s. It was not the euro as such that caused this; it has suffered and reflects the consequences of it. When divergence has occurred it originated in the application of autonomous policies without a care for their effect on the community. If the French economy “diverges” from that of Germany, it is not because of the single currency, it is because successive French governments have implemented policies to stimulate consumption via public debt and to restrict supply via reductions in working hours, whilst Germany on the other hand chose a strategy of business competitiveness. These autonomous policies have led to conditions that encouraged monetary tension in times of asymmetric shocks. Although the period of growth (2002-2008) adjusted to diverging policies, divergence fed by autonomous strategies has left the Europeans defenceless in the face of the crisis, which has been more or less serious in each of the States.

With the spread of austerity policies since the end of 2000’s and the spring of 2010, a type of convergence is occurring in European policies; but this has occurred in an emergency situation, and in much harder circumstances than if it had happened in a period of calm, when it was possible ride the wave of high cycles to reduce spending and debt. The crisis had to happen in order to speed history up and to take the euro zone in the right direction. A start to budgetary federalism came with the EFSF in May 2010, the means and intervention techniques of which were extended in July. Its durability after 2013, via the European Stability Mechanism (ESM), has been guaranteed, which encouraged French President Nicolas Sarkozy to say that Europe now had “a European Monetary Fund”. The EFSF can be used to guarantee the euro zone’s stability and to intervene on the secondary market. The European Central Bank has significantly extended and adapted its intervention techniques. Since it started its alternative assistance it has subscribed to 150 billion € in government securities to facilitate the zone’s stability.

The work undertaken by the President of the European Council, Herman Van Rompuy, to provide a political framework to these developments based on the work of an ad hoc group came to fruition in March. The most important initiatives comprised

extending the conditions of macro-economic surveillance and above all establishing the "European Semester": before transmission to National Parliaments, governments must present their budgetary plans to their partners.

The paradox of these initiatives is that they indicate the direction to follow – the integration of national policies and budgetary federalism – whilst limiting themselves – in terms of implementing immediate decisions – to half-steps. This is clearly linked to the room to manoeuvre that States concede to the community framework. We cannot continue to want one thing and the contrary as well. If some States absolutely want to retain economic strategies based on budgetary and monetary stimulation, they will have to recover their own national currencies so that they can enjoy an exchange rate as an adjustment variable. But those States, which consider that belonging to the euro is a political and/or economic imperative, must learn from this; that means relinquishing this type of strategy for ever –and fostering the construction of the political framework necessary for this type of development. In other words the economic imbalances of the euro zone that seemed to help the crisis grow have in fact strengthened the political aspects of monetary construction and have shown the limited results of intergovernmental methods. The emergence of a federal solution via the establishment of the EFSF, which lays the official foundations of European financial solidarity, has opened the way to effective solutions. Governments have understood that this is the direction to take to recover control of budgetary policy and to guarantee their credibility on the markets.

#### **European Union, Federalism Policy**

Federalism should no longer mean technocracy. On the contrary, the financial crisis has heralded the end of the approach to world problems simply through the prism of expertise. This does not mean it should be given up completely; it simply means removing the political dimension from problems for which the States and representative institutions must again take responsibility. Europe, like the rest of the world, fell into this trap and it now has to escape it. The European crisis has highlighted this. Building the institutions of European budgetary federalism, especially if it occurs in stages, calls for major political change. It would be clumsy to subordinate the settlement of the present crisis to political reforms that have to be undertaken long term. The debate over political change desired by 21st century Europe is not res-

tricted to settling the crisis in its financial aspect – even though the urgency or necessity and the future implications of this might be highlighted. Europe has the means to deal with its immediate problems. Therefore we have to stop Europe sitting down to wait for Godot.

In the short term, if we do not want the progression towards a community budget to seem like the relinquishment of national representations, especially in the Member States where parliamentary traditions are firmly anchored, greater involvement by the European Parliament and the National Parliaments in ongoing developments has to occur. In the more distant future Europe will have to look into the development of its institutions, otherwise conflicts between the various challenges that Europeans have to face will become unbearable, especially since national political structures, the seats of national sovereignty, will be powerless to respond. At this point in time we should simply stress that in spite of the failures of the referenda in France and the Netherlands in 2005, the emergence of a European opinion has grown – as seen in the Iraqi crisis or as the specifically European dimension of the present crisis reminds us. Of course national features have emerged in the crisis but European opinion is undeniably more aware that problems are increasingly similar and that their solution is to be found via greater solidarity, and not via selfish withdrawal into nationalism. Europeans have seen more clearly, whether this was in Ireland, Greece or elsewhere, the limits of narrow ideas of sovereignty, when States threaten to default and depend entirely on their partners for salvation. Even the most virtuous countries are now aware of the extremely negative repercussions that the default of some would have on them. In this crisis Europe has shown that far from being the destroyer of national sovereignty, it is rather the catalyst, the condition for its real rehabilitation.

#### **A Wise Heart for Europe**

It is important to note that in spite of how the ruling coalition might appear, calls for a more integrated Europe are growing in Germany, even though its very success means that it is taking most of the strain in Europe. The German Employment and Social Affairs Minister, Ursula von der Leyen recalled that "in major issues such as the budgetary policy, fiscality and the economy we are enjoying the advantages offered by Europe[2]". Wolfgang Schäuble, the German Finance Minister "personally" declared that he admitted the interest of a European Finance Minister. Finally former

## The Euro and the Debt Crisis: towards greater political integration

---

German Chancellor Gerhard Schröder pleaded for “a more European, a more integrated Europe[3]”, and for further transfer of sovereignty over to the European Parliament.

Under the impetus of such eminent politicians, it is up to France to take the opportunity of this new development in Germany. The adoption of the new aid plan to Greece on 29th September by the Bundestag in circumstances that surpassed bipartisan political splits, has to be considered as a further chance to strengthen the work undertaken over the last few months in support of an economic government as declared by Nicolas Sarkozy and Angela Merkel, on 16th August last. France must contribute to the construction of the community by taking the decisive step to readjust its budgetary situation, which it must believe is one of the basic conditions for the strength of monetary and financial structure.

On 22nd September last the Pope spoke to the Bundestag and exhorted German MPs to take inspiration from Salomon, who at the start of his reign, did not ask God for wealth and glory but to grant him a wise heart, i.e. with the gift of discernment.

We could extend this wish to all European leaders – since Europe has rarely found itself, as today, so close to the hour of truth.



---

**Author : Alain Fabre**

Graduate of the Political Studies Institute of Paris, Master in Political Science and Business Law; post graduate diploma in Banking and Financial Law - he started his career as an economist at the Bank of France (1988-1991). He then taught economics at the Institute for Political Studies of Paris (1989-1992). After joining the Caisse des Dépôts et Consignations his career continued with Cie Financière Edmond de Rothschild (1992-1999). In 1999 he created Victoria & Cie, a financial consulting company dedicated to businesses.

2. *Le Monde*, 6th September 2011.

3. *Le Monde*, 7th September 2011.

20112011.

You can read all of our publications on our site:  
[www.robert-schuman.eu](http://www.robert-schuman.eu)

Publishing Director: Pascale JOANNIN

---

THE FONDATION ROBERT SCHUMAN, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France, Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organisation of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.