
German Politics
Publication details, including instructions for authors and subscription information:
http://www.tandfonline.com/loi/fgrp20

# The Economics and Politics of the Euro Crisis

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Version of record first published: 16 Nov 2012.

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*This article addresses puzzles raised by the Euro crisis: why was EMU established with limited institutional capacities, where do the roots of the crisis lie, how can the response to the crisis be explained, and what are its implications for European integration? It explores how prevailing economic doctrines conditioned the institutional shape of the single currency and locates the roots of the crisis in an institutional asymmetry grounded in national varieties of capitalism, which saw political economies organised to operate export-led growth models joined to others accustomed to demand-led growth. The response to the crisis is reviewed and explained in terms of limitations in European institutions, divergent economic doctrines and the boundaries of European solidarity. Proposed solutions to the crisis based on deflation or reflation are assessed from a varieties of capitalism perspective and the implications for European integration reviewed.*



For the past three years, Europe has been mesmerised by the Euro crisis, namely the struggle to resolve the debt problems facing Greece, Ireland, Italy, Portugal and Spain (the GIIPS) without breaking up the monetary union or precipitating a wider financial crisis in Europe. This long-running drama has had serious economic consequences, especially for those who have lost jobs or income in its wake, and profound political implications for the future of integration in the European Union.

At the heart of the crisis are several puzzles. Commentary in the financial press has a Rashomon-like quality: after years of presenting economic and monetary union (EMU) as a great success, the media often present it now as an abysmal failure, as if it were incomprehensible how the Euro could have been created in the first place.[1] Why did the Europeans agree to a currency union apparently doomed to such problems? There are also clashing narratives about the roots of these problems. In northern Europe, the crisis has been blamed on the fiscal fecklessness of southern European governments. While many in the south accept this critique, they attribute the depth of the crisis to anaemic support from their northern neighbours and the harsh conditions imposed in exchange for it. Where do the roots of the problem lie? The crisis also raises questions about the future of Europe. Will the crisis ultimately advance the process of political integration in the European Union (EU) or impede that process?

To these issues, this article brings a varieties-of-capitalism approach, which highlights the tenuousness of the assumptions on which EMU was founded and provides a distinctive diagnosis of the roots of the crisis. Many supporters and critics of the Euro

German Politics, Vol.21, No.4, December 2012, pp.355–371
ISSN 0964-4008 print/1743-8993 online
http://dx.doi.org/10.1080/09644008.2012.739614 

alike have failed to appreciate the ways in which the organisation of political economies conditions what governments can and will do. Moreover, the response to the crisis is still being driven by some of the illusions on which the Euro was founded. Thus, this approach also calls into question the economic value and political reasonableness of the current response to the crisis. In the coming years, the fate of the EU and its member states will depend on how well such issues are understood. The argument proceeds in three steps. First, I return to the early 1990s when agreement was reached on EMU to ask: why did European policy-makers think monetary union was viable? Second, I ask: what happened after the launch of the Euro in 1999 to cause the problems apparent today? Finally, I explore the implications of this analysis for efforts to resolve the crisis and for European integration more generally.



## PERSPECTIVES ON THE EURO AT ITS INCEPTION

Social science is good at reading history backwards. But much can also be learned from reading history forward, that is, by considering what the terrain looked like when policy-makers took steps that may seem ill-advised today.[2] What was on the mind of policy-makers when the ground was laid for EMU in the Maastricht Treaty of 1992?

From a purely economic perspective, the prospects for the Euro did not look especially auspicious in 1992. Economic theory suggested that the Eurozone was susceptible to asymmetrical shocks on the demand and supply sides of the economy and hence not an 'optimal currency area'.[3] Moreover, the prevailing European Monetary System (EMS) of managed exchange rates was working moderately well, even if George Soros showed it did not work perfectly by making a $1 billion bet against sterling in 1992. Thus, EMU was essentially a political project, initiated by President François Mitterrand of France in line with 'une certaine idée de l'Europe' in order to bind a newly unified Germany to Europe – more or less in exchange for French agreement to German unification.[4]

In Chancellor Helmut Kohl, Mitterrand found a willing partner. German opinion was divided and the Bundesbank especially reluctant to accede, but it agreed in return for a Stability and Growth Pact (SGP) that put limits of 3 per cent on government deficits and 60 per cent on the national debt of the member states.[5] From a German standpoint, the Euro had some attractions. It would prevent Germany's principal trading partners from making their products more competitive against German ones by devaluing their currencies against the Deutschmark, a problem Germany faced repeatedly under EMS. Moreover, as Barry Eichengreen has noted, EMS provided an economic equilibrium but not a political one: its exchange rates remained vulnerable to protectionist pressures for devaluation, a possibility EMU would pre-empt.[6]

Thus, the political will was there, and the residual issue seemed to be whether EMU was economically viable. When the Werner report mooted a similar project in 1969, it went nowhere. However, mainstream economic doctrine changed during the 1980s in directions that made monetary union seem more feasible and left a distinctive mark on the institutional structure of the new union.[7] Two aspects of the new economic doctrines were especially consequential.

First, mainstream economics moved away from the Keynesian view that active fiscal policy was crucial for stabilising the economy – towards the monetarist view that fiscal policy is not stabilising and monetary policy has few lasting effects on the ‘real’ economy. The implication was that fiscal policy should remain roughly neutral and monetary policy rule-based and targeted on inflation.[8] These doctrines influenced the institutional structure given to the new monetary union. They authorised a union that put monetary policy in the hands of a central bank entirely independent of political control and one without the institutional capacity to co-ordinate fiscal policy over the medium term.[9] The crude limits placed on debt and deficits of the SGP were deemed adequate.

Second, in keeping with the view that demand management was largely irrelevant to growth, the new doctrines held that economic growth depended on structural reform to the supply side of the economy, and ‘structural reform’ meant measures to make competition in markets for goods, labour and capital more intense. The implication was that all the member states of EMU could and should use the same formula to secure economic growth; and many believed that competition under the stringent conditions imposed by a single market and common currency would force structural reform on the member states and lead to institutional convergence in their political economies.[10] These were the terms on which EMU was endorsed by the Maastricht Treaty of 1992 and formally inaugurated in 1999.



## THE ROOTS OF THE EURO CRISIS

Why did the new monetary union face a crisis severe enough to threaten its existence barely ten years after its inauguration? Some are tempted to blame the bond markets, whose ruthless zeal for profits turns speculators into national executioners. But bond markets are simply strident messengers about problems originating elsewhere, and many factors converged to produce this crisis. At a fundamental level, it was the European reflection of a global debt crisis built on ten years of incautious expansion in worldwide lending.[11] For that one can blame both the borrowers and the lenders, but governments can also be faulted for accommodating this spending spree, notably in Greece, Ireland and Spain but perhaps also in northern Europe, whose financial institutions did much of the relevant lending. Of course, the tepid initial response of the European Union to the crisis also intensified it.

However, the form taken by the crisis in Europe, which arrayed the GIIPS of ‘southern’ Europe against their creditors in ‘northern’ Europe, originated in the structural strains generated when different types of political economies were joined in a currency union. This proposition diverges from conventional views in two important respects. Many commentators have argued that the crisis is rooted in a failure of political will: if the governments of southern Europe had pursued different policies, there would have been no crisis. Of course, there is a kernel of truth in this: the proximate cause of declining confidence in the bond markets lay in increases in public or private sector debt that might have been avoided if governments had taken steps to limit government spending in the case of Greece, to restrict bank lending in Ireland, to dampen down an asset boom in Spain or to limit commercial borrowing in Portugal. But this focus on ‘political will’ lacks realism. It downplays the difficulty of such tasks when monetary policy is in the hands of a European Central Bank (ECB) and neglects the ways in which the organisation of the political economy conditions the feasibility of economic policies.

Others have argued that the crisis might have been prevented by more assertive structural reforms focused on competition in markets for goods, labour or capital. That argument is usually premised on the view that all developed economies are so similar that identical policies are appropriate for them. But such prescriptions construe the political economy in overly narrow terms and ignore the ways in which national variations in the organisation of the political economy promote alternative growth paths that may demand different approaches to policy.[12] The organisation of the political economy must be seen in terms that go beyond asking whether or not its markets are ‘flexible’.

How did variations in the organisation of the European political economies generate structural strains within EMU? Consider the economic strategies governments typically pursue and how entry into a currency union affects them. To stylise slightly, within the developed economies of the OECD, two broad growth strategies are typically pursued.

One can be described as an ‘export-led’ growth strategy. Governments pursuing such strategies depend on world demand to fuel economic growth. This strategy dictates relatively neutral macroeconomic policies, because growth is not primarily dependent on domestic demand and expansionary policies often fuel wage increases that threaten the competitiveness of exports.[13] The success of an export-led growth strategy depends on the capacity of national firms to ensure their products remain competitive on international markets. Broadly speaking, there are three ways firms can do that. One is to hold down labour costs. A second is to produce high value-added goods in a context of continuous innovation so that the quality of the products and the efficiency of production processes outpace those of competitors. A third approach is to substitute capital for labour over time in order to generate progressive improvements in the quality of the products and the productivity of labour.

However, it is not easy for firms to accomplish any of these endeavours and their capacities to do so depend on features of the political economy developed over long periods of time.[14] To take a classic example, Germany is ideally equipped to operate an export-led growth strategy.[15] Its industrial relations institutions promote the co-ordinated wage bargaining that can be used to hold down labour costs. As a co-ordinated market economy, it has comparative advantages in incremental innovation and the production of high value-added goods; and its firms have become accustomed to substituting capital for labour, encouraged by high wage costs, supportive financial institutions and a vocational training system that supplies highly skilled labour. Parallel institutional features in the other co-ordinated market economies of northern Europe have facilitated export-led growth strategies in the Netherlands, Austria, Denmark and Finland.

For these countries, entry into EMU posed few problems. A fixed internal exchange rate gave them an unprecedented advantage in the markets of their neighbours, and membership in a variegated union held down the external exchange rate of the Euro. Without a national monetary policy to counteract excessive wage demands, such countries might have had difficulty co-ordinating wage bargaining, but the ECB kept a close eye on German wage settlements and Germany’s neighbours effectively targeted the latter to hold down their own wages. Thus, inside EMU, the northern European countries could pursue the export-led growth strategies to which they had long been accustomed with considerable success.

The alternative strategy often pursued by OECD countries is to pursue growth led by domestic demand, fuelled periodically by macroeconomic expansion and a tolerance for asset booms. This type of strategy is common in liberal market economies, which usually lack the capacities for sustained wage co-ordination and incremental innovation that make an export-led growth strategy feasible. In countries where trade unions are weak, as in the USA, this kind of strategy can often be operated without significant levels of wage inflation. Where trade unions are stronger, demand-led growth is often accompanied by higher levels of inflation; and here the success of the strategy depends on periodic depreciation of the exchange rate in order to offset the effects of inflation on the competitiveness of exports, while increasing the price of imports so as to sustain the balance of payments.[16]

Prior to 2000, most of the southern European economies operated this kind of demand-led growth strategy, since the organisation of their political economies made export-led growth infeasible. Spain, Portugal, Greece and Italy inherited fractious labour movements divided into competing confederations that allowed for periodic social pacts but made sustained wage co-ordination difficult; and they lacked the institutional capacities for co-ordinated skill formation and incremental innovation normally required for successful export-led growth.[17] Many of their firms rely on low-cost labour and have been slow to substitute capital for labour or to move into high value-added production.

For these countries, entry into monetary union offered as many handicaps as advantages. Entry lowered transaction costs and the conditions imposed during the transition to monetary union helped governments secure some wage restraint. But entry also made it impossible for these states to devalue against their principal trading partners in order to offset the inflationary effects of demand-led growth on the competitiveness of their products.

Therefore, although largely unacknowledged, a basic asymmetry was built into EMU from its inception. The northern European political economies entered EMU with institutional frameworks well suited to the export-led growth strategies that offer the best route to economic success in such a union. The southern European economies entered EMU with institutional frameworks badly suited to effective competition within such a union and they lost the capacity to devalue on which many had long depended.

These observations go a long way towards explaining the trajectory of economic performance in the first decade of the new currency union. Germany, Belgium, the Netherlands, Austria and Denmark pursued strategies of competitive deflation – marked by relatively tight fiscal stances, low wage increases, incremental innovation and the gradual substitution of capital for labour. Their patterns of economic performance displayed the characteristic effects of such a strategy: growth was led by exports rather than by domestic demand, based on stable or declining unit labour costs.

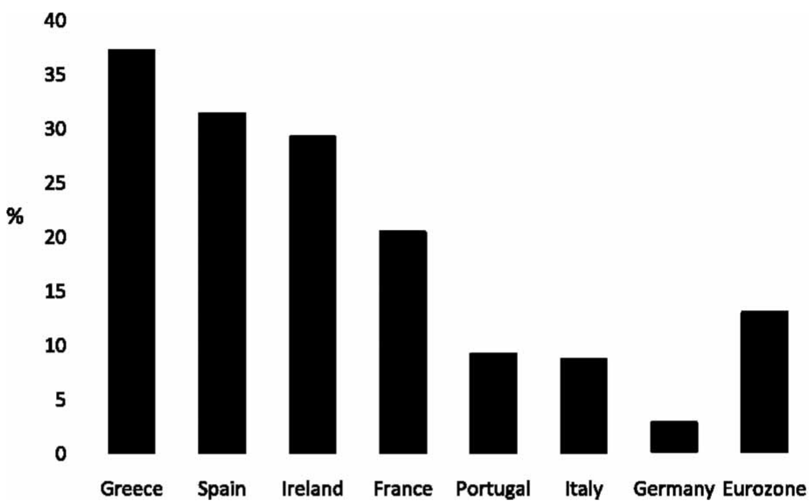
By contrast, the countries of southern Europe, including Spain, Portugal, Greece and Italy, continued to pursue relatively expansionary fiscal policies oriented towards the growth of domestic demand. However, since these countries could no longer devalue their exchange rates against their principal trading partners, their patterns of economic performance began to display some perverse effects. Economic growth was relatively rapid in southern Europe after 1999, but it was marked by the expansion of domestic demand and rates of inflation higher than in the north, which led to deteriorating relative unit labour costs and declining shares of world exports (see Figures 1 and 2).

Moreover, once initiated, EMU itself had several effects that encouraged the countries of southern Europe to continue to pursue demand-led growth. Entry into a monetary union seen by international markets as relatively safe because it was anchored by Germany lowered their borrowing costs; and, because the ECB had to operate a common monetary policy, it could not dampen down inflation in the south without stalling growth in the north, an outcome it wished to avoid. Thus, higher rates of inflation lowered the real cost of borrowing in the south even further. At the same time, the export-led strategies of northern Europe generated large balance of payments surpluses that the northern banks were only too happy to lend to southern firms and governments. Thus, an influx of cheap credit encouraged demand-led growth in southern Europe. But, as their levels of debt increased, the GIIPS were left vulnerable to the kind of global financial crisis sparked by developments in the American economy in 2008.

## A PATH NOT TAKEN?

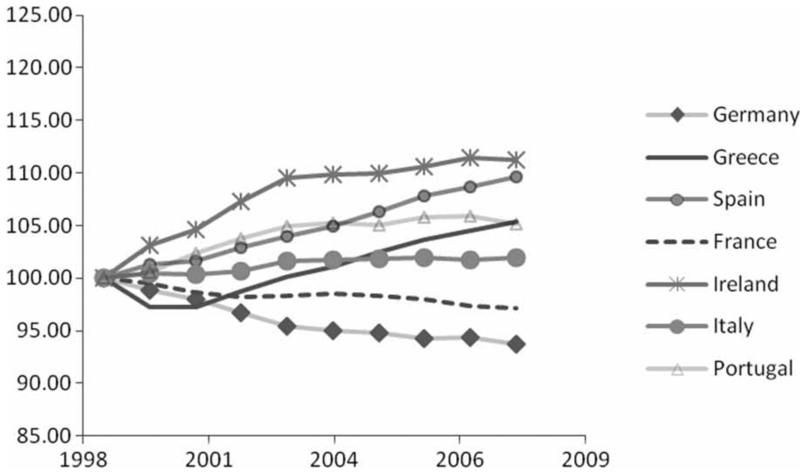
In the wake of the Euro crisis, many have blamed it on the economic policies pursued in southern Europe. As Boltho and Carlin observe, the Euro crisis is associated, not with the asymmetric shocks that once worried analysts, but with asymmetric policies.[18]

FIGURE 1
GROWTH IN DOMESTIC DEMAND, 1999–2009 (%)




*Source*: S. Tilford, 'How to Save the Euro', *Centre for European Reform Essays* (September 2010).

FIGURE 2
REAL EFFECTIVE EXCHANGE RATE RELATIVE TO THE EUROZONE (1999 = 100)




*Source*: Eurostat. HICP deflator.



Could those governments have reasonably been expected to pursue different policies? Much depends on the precise tenor of such claims.

In one form, influential in northern Europe, the claim is that the southern European countries should have pursued the kind of economic strategies found in the north, oriented to export-led growth. However, that argument ignores the extent to which the feasibility of an economic strategy depends on the structure of the economy. As I have noted, export-led growth strategies were not practicable in the context of the institutional structure of the southern European economies. In the absence of a trade union movement and employers' organisations structured so as to make sustained wage co-ordination possible, preventing the increase in unit labour costs that led to a deterioration in the trade balance would have required fiscal policies so austere that they would have stifled growth.[19]

Others claim that, instead of taking advantage of membership to implement growth-oriented reforms, the governments of the GIIPS wasted their first decade in the single currency. There is some truth in this, but considerable variation across countries. On the OECD index for product market regulation, a good indicator of structural reform, for instance, the improvement in the south was roughly equivalent to that in the north (see Table 1). Moreover, as Table 2 indicates, the budgetary record of the GIIPS was far from uniformly bad. Germany and France were the first Eurozone countries to violate the terms of the Stability and Growth Pact; Ireland and Spain never did so before the onset of the crisis, and even Italy was running a primary budget surplus by 2011.

Of course, the exceptional case is Greece where the roots of the problem lie in political as well as economic development.[20] Ranked among the highest EU countries on standard corruption scores, successive Greek governments took advantage of lower borrowing costs to expand a public sector closely associated with political patronage

TABLE 1
IMPROVEMENT IN PRODUCT MARKET REGULATION 1998–2003

| | PMR 1998 | PMR 2003 | Improvement |
|---|---|---|---|
| France | 2.5 | 1.7 | 0.8 |
| Germany | 1.9 | 1.4 | 0.5 |
| Netherlands | 1.8 | 1.4 | 0.4 |
| Ireland | 1.5 | 1.1 | 0.4 |
| Italy | 2.8 | 1.9 | 0.9 |
| Portugal | 2.1 | 1.6 | 0.5 |
| Spain | 2.3 | 1.6 | 0.7 |

*Source*: Author's calculations based on P. Conway, V. Janod and G. Nicoletti, 'Product Market Regulation in OECD Countries 1998–2003', *OECD Economics Department Working Papers* No. 419 (Paris: OECD, 2005).

and failed to reform a tax system beset by non-compliance. As a result, the level of public sector debt rose to 113 per cent of GDP in 2009 and the revelation that the Greek budget deficit was more than three times as high as previously reported touched off the sovereign debt crisis. However, Greece is a nation of 11 million people with an economy smaller than that of the state of Massachusetts. Using it as the prism through which to view the crisis is to invite misdiagnosis.

The crisis is better seen as a classic debt crisis, fuelled by increasing financial speculation and an overweening faith in lightly regulated markets, much like the crisis that exploded in the USA in 2008. The policy mistakes were similar on both sides of the Atlantic. Across Europe, banks were allowed to overextend their lending, often taking exorbitant risks, notably on overheated property markets in Ireland and Spain that the authorities failed to dampen down. Governments paid insufficient attention to rising trade imbalances, partly because these were readily financed from northern Europe. In these respects, the policy-makers of northern as well as southern Europe can be faulted: lenders are as responsible as borrowers when tens of thousands of risky loans go sour.

TABLE 2
CUMULATIVE DEFICITS AND BANK ASSETS 2000–7

| | Number of deficit violations | Cumulative deficit (% GDP) | Bank assets as % of GDP, 2007 |
|---|---|---|---|
| France | 3 | 21.7 | 373 |
| Germany | 4 | 17.7 | 314 |
| Netherlands | 1 | 4.7 | 382 |
| Ireland | 0 | −11.9 | 705 |
| Italy | *5* | 22.9 | 220 |
| Portugal | 4 | 28.9 | 240 |
| Spain | 0 | −2.3 | 280 |
| Greece | 8 | 40.0 | 157 |

*Source*: R. Baldwin and D. Gros, 'Introduction: The Euro in Crisis – What to Do?', in R. Baldwin, D. Gros and L. Laeven (eds), *Completing the Eurozone Rescue: What More Needs to be Done?* (London: Centre for Economic Policy Research, 2010), p.5.

## THE RESPONSE TO THE CRISIS

It is beyond the scope of this article to recount the history of the crisis.[21] The revaluation of Greek budget deficits in 2010 turned a liquidity squeeze in the European financial system into a sovereign debt crisis, and the IMF and EU bailed out Greece in return for deep budgetary austerity and promises of economic reform. The attention of the markets turned to Ireland, after its government unwisely guaranteed the bonds of its grossly overextended banks, and it too was forced to accept European loans in exchange for fiscal austerity.[22] Portugal was forced into a similar deal in 2011 and new governments in Spain and Italy adopted austerity programmes under pressure from the bond markets and the ECB, followed by a bailout of the Spanish banks in 2012. However, the public sector debt of Greece still seems unsustainable, and Italy and Spain continue to face threatening pressure in the markets for sovereign debt. The fate of the Euro hangs in the balance.

Three features of the European response to the crisis stand out. First, it should be noted that there *has* been a concerted European response. Under pressure from the bond markets, the more prosperous countries of Europe have made hundreds of billions of Euros in loans available to others in the Eurozone. This was not a foregone conclusion because the agreement establishing EMU specified that it was not to be a 'transfer union' whose member states are obligated to bail each other out.

However, the reaction of the European governments to the crisis was painfully slow and still insufficient, as of the fall of 2012, to restore confidence in the bond markets. One half-measure has been followed by another, reminding many of Winston Churchill's observation that the Americans can always be counted on to do the right thing … after they have tried everything else. An initial disinclination to support Greece gave way to a rescue orchestrated by the EU in May 2010, followed by similar rescues for Ireland and Portugal in November 2010 and May 2011, and agreement to establish a short-term European Financial Stability Facility (EFSF) to shore up the markets for European sovereign debt, finally ratified in October 2011. The Greek debt held by the private sector was restructured in March 2012 and the EFSF transformed into a European Stability Mechanism (ESM) equipped with €500 billion and a longer-term remit, albeit still not fully operational in late 2012. That was followed by efforts in early 2012 to establish a 'fiscal compact' strengthening the budgetary rules of EMU, supplemented in June 2012 by a modest effort to assemble investment funds for southern Europe and a promise to establish a system for European banking supervision coupled to direct support for troubled banks from the ESM.

Third, the costs of adjustment have been imposed disproportionately on the GIIPS. In return for EU support, Greece was forced to attempt one of the most drastic programmes of fiscal austerity in modern history aimed at reducing its budget deficit by eleven percentage points of GDP within three years. Ireland was required to reduce its budget deficit by nine percentage points of GDP in five years, and Portugal by six percentage points in three years. In addition, the EU demanded a serious acceleration in structural reforms. The result was a precipitous rise in unemployment and rapid declines in income in many parts of southern Europe.

Conversely, the costs of adjustment born by northern Europe were relatively limited at least through 2012. Aid to the GIIPS took the form of loans which would, in principle if ultimately perhaps not in fact, be repaid, and contributions to the EFSF were guarantees for its borrowing rather than direct transfers of funds. Moreover, with this aid, much of which went to service existing debts, the countries of northern Europe were essentially bailing out their own banks, which held massive sums of southern European debt (see Table 3). The case of Greece is emblematic. While private bond-holders suffered losses when pressed into a ‘voluntary’ restructuring of its sovereign debt, these were relatively modest, and Greek debt held by the ECB or EFSF has not yet been restructured, although it may have to be. As a result, more than two-thirds of the bailout funds transferred to Greece from the EFSF and IMF are being used to pay interest on the existing debt, while barely a third flows into the government’s coffers.[23]

The European Central Bank has played an important role in this response to the crisis. By providing emergency liquidity, the ECB has kept many banks in southern Europe afloat and an initial effort to purchase sovereign debt on the secondary markets allowed many northern institutions to unload what were now risky assets, averting a Europe-wide financial crisis. Large lending programmes in December 2011 and February 2012 that offered financial institutions €1.2 trillion in three-year loans at low interest rates against collateral encouraged some banks to purchase sovereign debt, thereby easing pressure on their yields. As a result, an increased proportion of southern debt is now held, outright or as collateral, by the ECB, and the transnational character of financial flows in Europe has eroded, as larger proportions of the sovereign debt of each country in the south are now held by its own banks. If, as seems likely, the ECB embarks again on a large programme of purchases of sovereign debt, while the cost of borrowing in the south will decline, even greater proportions of its debt will be held by European institutions.

The effectiveness of this response can be judged on two dimensions, first against its immediate objective, which was to restore confidence in the bond markets, thereby lowering the costs of borrowing in southern Europe, and, second, against the longer-term objective of restoring prosperity in Europe. With respect to the first objective, the response of the EU has been largely unsuccessful and far more costly than it might have been if decisive action had been taken earlier. A bond market crisis is

TABLE 3
SOUTHERN EUROPEAN DEBT HELD BY BANKSIN THE CORE OF THE EUROZONE (€ BILLIONS)

| | 1999 (4th Q) | 2009 (4th Q) | % change |
|---|---|---|---|
| Portugal | 26 | 110 | 320 |
| Ireland | 60 | 348 | 481 |
| Greece | 24 | 141 | 491 |
| Spain | 94 | 613 | 554 |
| Italy | 259 | 822 | 217 |
| Total | 463 | 2,034 | 340 |

*Note*: Eurozone core is Ger, Fr, Au, Be, Neth.
*Source*: R. Baldwin and D. Gros, ‘Introduction: The Euro in Crisis – What to Do?’, in R. Baldwin, D. Gros and L. Laeven (eds), *Completing the Eurozone Rescue: What More Needs to be Done?* (London: Centre for Economic Policy Research, 2010), p.13.

ultimately a crisis of confidence with self-reinforcing dynamics. The best way to address it is to assure bondholders that default is out of the question. Given such assurances, the cost of borrowing falls, and the more resolve the authorities can show, the less capital they have to spend to restore confidence.

The most effective way to restore confidence would have been for the ECB to indicate that, if needed, it would purchase unlimited amounts of sovereign debt, as national central banks typically can. The problem, of course, is that the treaties of the EU forbid the ECB from doing that directly. Thus, decisive action would have required a creative legal interpretation built on the mandate of the ECB to maintain financial stability in Europe or the granting of a banking licence to a special purpose vehicle, such as the EFSF, empowered to purchase sovereign debt. A second-best strategy might have been for the member states to guarantee Greek and Irish debt, hoping to nip the initial crisis in the bud, possibly supplemented by the issue of joint Eurobonds to support other countries susceptible to contagion. These would have been radical measures, effectively transforming EMU into a fiscal union, and thus very difficult to agree quickly, but desperate times call for radical action. The EU missed an opportunity, if a difficult one, and the alternative has been costly and far from successful.

Much the same can be said of efforts to restore economic growth in Europe. Two years into the crisis, much of the continent is now close to recession, the GIIPS face levels of unemployment that are fuelling extremist politics, and the €130 billion investment plan announced in June 2012 is unlikely to restart growth. On this front, the primary alternative would have been for the northern Europeans to provide more extensive financial support to the southern European countries, on terms that allowed them to reduce their budget deficits more slowly, combined with reflation in the north designed to bring European rates of inflation into the 3–5 per cent range. Since inflation erodes the value of existing debt, that strategy would have required the northern European banks and states to share more of the costs of adjustment, but it would likely have improved growth prospects for the continent as a whole.

In the absence of such co-ordinated reflation, many policy-makers repeat the familiar mantra that growth in the south will follow from ‘structural reform’. But this is merely a convenient myth. Making competition in markets for goods and labour more intense may increase the efficiency of some economies over the long run, but it is unlikely to raise rates of growth in the short or medium term. The EU still lacks a viable growth strategy.

To the extent that Europe is facing a classic debt crisis, growth in the medium term also depends on restructuring the debt of the public and private sectors.[24] The banks of Ireland and Spain hold hundreds of millions of Euros in loans that will likely never be repaid; and it is doubtful whether the Greek government can honour the debt that remains even after an initial restructuring. What appears as a sovereign debt crisis is actually a crisis of the European financial system.[25] But European governments are only beginning to grapple with the problem of deciding whose loans will not be repaid, and the longer that process is delayed, the more costly it will be. In the meantime, many southern banks are living on life-support from the ECB, in the form of loans based on increasingly dubious collateral, and northern banks have cut back on their lending to meet tighter capital requirements imposed in the wake of the financial crisis – a serious problem because European firms depend especially heavily on bank lending for finance.

## EXPLAINING THE RESPONSE TO THE CRISIS

Why has the response to the crisis been so halting, so focused on imposing the costs of adjustment on southern Europe, and less effective than it might have been? Four factors have conditioned the character of the response: the intractability of the problem; deficiencies in European institutions; divergent diagnoses of the problem; and the boundaries of European solidarity.

No one should underestimate how difficult the problems facing the EU have been. Its governments faced an intractable paradox. To avoid yields on sovereign debt rising to unsustainable levels, the EU had to reassure the bond markets that government debt would be repaid, but, once governments had rescued banks, some of the debts were so large that they could not readily be repaid: for the continent to return to growth, they would have to be restructured. Moreover, there was a real possibility at the outset of the crisis that any immediate restructuring of the debt would lead to widespread bank failures and continental financial crisis. The ECB pumped liquidity into the system to avert that prospect and, if the legal obstacles were overcome, it could have guaranteed sovereign debt in nominal terms; but losses on that debt would eventually still have to be allocated – a painful and perplexing issue. Although more decisive action sooner would have reduced the costs of such a process, it was bound to be a difficult one.

In that context, it is not surprising that EU institutions proved inadequate to the task. As I have noted, the ECB was legally prohibited from making direct purchases of sovereign debt precisely in order to allay fears that monetary union might involve transfers of funds between the member states; but allocating the costs of adjustment implicitly requires such transfers, and the EU has no viable way of doing that other than by inter-governmental negotiation. As a result, each step taken to support the governments under pressure from the bond markets required protracted negotiations and unanimous approval, often after consultation with national parliaments. Thus, the EU was institutionally ill-equipped to take the kind of decisive actions that would have reassured the markets; and, when it became clear how arduous such negotiations were going to be, the capacity of the EU to make credible promises declined. Paradoxically, therefore, precisely because the efforts to resolve the crisis of confidence were so strenuous, over time it has become increasingly difficult for the EU to summon up the credibility to do so.

For similar reasons, it has been hard for the EU to restructure the debt. Although vague plans have now been made for some sort of banking union, in its absence, there has been no effective means for allocating the cost of writing-down the debt among institutions or countries. Indeed, for some months after its beginning in 2010, policy-makers presented the crisis as a policy problem for the GIIPS rather than as a European banking crisis, in effect publicly ignoring the possibility that some of the costs should be borne by lending institutions in the north. Although the restructuring of Greek debt was an accomplishment, it is telling that only the segment of that debt held by the private sector was restructured. Governments have yet to decide what they will contribute to writing down that debt, even though some contribution from them seems inevitable.

At each step, the response to this crisis has resembled a giant co-ordination game, in which the benefits of reaching agreement outweigh the costs of failing to do so, but any specific agreement distributes the relevant benefits and risks differently. Thus the politics of response has been dominated by intense conflict about who would bear those risks. Alongside the obvious conflict between governments of the north and south was a parallel conflict between the ECB and the member governments about that issue. Because of this politics, the EU could not manage its strategic interactions with the bond markets effectively, thereby increasing the costs of response.

Those problems were compounded by uncertainty about how to diagnose the economic problem and by national variation in that diagnosis. The initial public statements of German political leaders conveyed the impression that they did not initially realise that market pressure on Greece posed an existential threat to the Euro: they treated the problem as if it were simply a matter of the fiscal fecklessness of the Greek government (as it surely was) that could be rectified by imposing budgetary austerity on Greece (which it could not). Even after the full dimensions of the crisis became clear, there remained a striking divergence between those who argued that it could be resolved by fiscal austerity and others who maintained that reflationary measures in southern as well as northern Europe would be necessary.

In some measure, this division reflected divergent preferences about whether the north or south should bear the costs of the crisis. But it also mirrored longstanding differences in the economic doctrines espoused by German economists, many of whom were linked to the Freiburg school of economics and committed to balanced budgets, and the economists of France and Italy who often held more Keynesian views. Behind these schools of thought were deeper philosophies of governance: the Keynesians tended to favour activist government, while the ordo-liberals of Germany saw government as an institution that should 'steer' society only gently if at all and operate as a factor of stability, providing sound money and a general framework for social market economies whose sources of dynamism lie in the private sector.[26] It is notable that the ordo-liberal approach dovetails nicely with the institutional structures underpinning export-led growth in northern Europe, while Keynesian approaches are more congruent with the demand-led growth models of southern Europe.[27]

At a deeper level, the torturous politics of the Euro crisis betrays the difficulty the member governments have had coming to grips with the prospect that the survival of the Euro will require substantial transfers of resources, at least temporarily, across national borders. The single currency was initiated on the premise that it would require no such transfers, and no northern European government has prepared its electorate for that eventuality. Thus, the crisis has thrown the limits of European solidarity into sharp relief.

Social solidarity has long been a distinctively European value. The European social model specifies that those who are better off should help the worse off, as the structural funds of the EU do on a modest scale.[28] But it is now clear that, for the most part, feelings of social solidarity stop at national borders. Asked to rescue those suffering in southern Europe, many northern Europeans have balked. The sense of European identity for which the EU strives has been exposed as a thin veneer laid over essentially strong national identities; and that too stands in the way of an effective trans-European response to the crisis.

This problem was exacerbated by the initial response to the crisis in northern Europe. Like national identity, social solidarity is a social construction, sensitive to the ebb and flow of political appeals. Egged on by an increasingly nationalist press, the initial reaction of the German government was to blame the crisis on the fiscal imprudence of the southern Europeans. The latter were pilloried for retiring too early, not paying their taxes, and living high off the hog during the first decade of the Euro, when Germans were restraining their wages in order to recover the international competitiveness they had lost in the wake of reunification.[29] Typical of such pronouncements was Chancellor Angela Merkel's remark in March 2011 that 'member states face many years of work to atone for past sins'.[30] Little mention was made of the decisions of German banks to make profitable but overly risky loans to southern European firms and governments.

After a decade in which they had subsidised the eastern Länder in order to manage reunification, many Germans worried quite reasonably that they might be asked to send subsidies to the European periphery for another indefinite period. But the initial framing of the crisis in such moralistic terms, often linked to failures of national character, eroded whatever sense of pan-European solidarity might have been available; and, by the time northern politicians came round to declaring their wholehearted support for Europe, popular perceptions had already been poisoned. Parties of the radical right and left exploited the nationalist reaction, causing dire problems for the Dutch and Finnish governments, who found it increasingly difficult to assemble the votes for rescue efforts for the south. In sum, the short-term response of the northern governments, while electorally popular, magnified the long-term problem of mobilising legislative consent for measures to sustain the Euro.



## THE WAY FORWARD

While Nero fiddled, Rome burned. By 2012, levels of unemployment reached 15 per cent in Portugal, 22 per cent in Greece and 24 per cent in Spain. Between 2009 and 2011, average wages fell by more than 20 per cent in Greece, where the suicide rate also doubled.[31] Moreover, the austerity programmes designed to restore fiscal balance in these economies faltered, as the denominator in the ratio of debt to GDP dropped faster than the numerator in most of them.[32]

The impact of the crisis on European integration has been broadly negative. On the one hand, efforts to shore up the Euro have inspired more intensive co-ordination of fiscal policy and movement towards a banking union, which would see the ECB exercise more supervision over European banks and some sharing of the costs of rescuing them. On the other hand, instead of accelerating European integration, the crisis has exposed its fault lines. The Parliament and Commission have been relegated to the sidelines, and inter-governmental bargaining has come to the fore, as rescue packages were negotiated by member governments in a seemingly endless series of summits.[33] The framing of the crisis as a matter of national fiscal profligacy, rather than as a European banking crisis, has undercut sentiments of European solidarity on which popular support for further integration ultimately depends.

Many European leaders, including Chancellor Merkel, have declared themselves in favour of 'more Europe' but there is no obvious consensus on what that means. If the

Euro is to survive, more intensive fiscal co-ordination in the Eurozone will be required. However, there is no agreement on what kinds of fiscal policies are appropriate for the continent. In December 2011, a fiscal compact specifying balanced budgets was negotiated. But differences across the varieties of capitalism of Europe call the viability of that compact into question. For the export-oriented economies of northern Europe, broadly neutral budgets often make sense, because more reflationary policies can push up wages, undermining the competitiveness of the export sector.[34] By contrast, in economies where growth is more dependent on domestic demand, flexible macroeconomic policies that are sometimes more reflationary can be appropriate. Thus, organisational differences across the European political economies militate against fixed fiscal rules, but Europe still lacks an institutional framework for agreeing and policing more flexible fiscal policies.

The common view that reducing the imbalances on current accounts within the Eurozone is the key to resolving its problems confuses the symptoms for the disease. The real issue is *how* to close these imbalances. Some suggest deflation to reduce imports in the south, while others urge reflation on the north. In the near term, it is desirable for the surplus countries of northern Europe to expand domestic demand, as Germany has been doing, and for the deficit countries of southern Europe to promote exports, as Ireland and Spain have with some success. As I have noted, however, it is not practicable for the export economies of northern Europe to maintain highly expansionary macroeconomic policies over the long term, and the alternative, namely, sustained deflation in the south, implies significantly lower rates of growth there.

Whether the Euro will survive in its current form remains a matter of doubt. Born of political will, it may well endure on that – who cannot appreciate the palpable sense of integration that flows from the use of a common currency. But the economics militate against easy solutions. It is difficult to see how the southern European economies can sustain their international competitiveness without the capacity to devalue periodically against their principal trading partners. The alternatives they have are to dismember union movements that have historically been powerful and will not go quiet into that good night, to reassemble them into effective agents for wage co-ordination, as Ireland did before the crisis, or to operate policies so deflationary that they restrain unit labour costs at the expense of stifling economic growth. Something like the Irish solution may be possible in the medium term: many southern European countries have had intermittent successes with social pacts.[35] However, the idea that, with effective reform, these economies can mirror the German economy is another of those mirages that is getting in the way of genuine solutions to the problems.

In the immediate future, the fate of the Euro will turn on the willingness of the northern Europeans to extend even more credit to their neighbours for an indefinite period and on the capacity of southern electorates to tolerate debilitating austerity programmes. Both are distinct possibilities but, in the wake of two narrow Greek elections and the collapse of a Dutch government, far from assured. Moreover, as the crisis of confidence drags on, the chances of finding a successful way to resolve it recede. The capacity of the EU to restore the confidence of the markets in the stability of the single currency depends on the credibility of its commitment to do so. But, as national parliaments put more restrictions on the actions of governments, it has become increasingly difficult for the member states to make pronouncements that are credible. Even the ECB, whose guarantee might once have stemmed the tide, is losing credibility as the potential costs of its actions to the member states rise and dissent on its governing board continues. There is a self-defeating dynamic at work that those seeking to sustain the Euro will have to overcome.

Without doubt, this is the most serious crisis the EU has faced since its inception, with the potential to open up durable fissures among its member states. However, the capacity of the European states to turn a crisis into a crucible for further integration, as the Single European Act did, should not be underestimated. Given enough time, they may well be able to do so again, but will the financial markets and electorates of Europe give them that time? Those are the open questions of the day.



### ACKNOWLEDGEMENTS

This article is based on the Annual Lecture given to the International Association for the Study of German Politics in London, May 2011. For research assistance, I am grateful to Neeral Gandhi and Maria Theophanous.

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