CURRENT HISTORY

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"A major challenge for policy makers lies in the fact that they may have to move forward with a deepening of integration at a time when the EU and the euro area confront a growing crisis of acceptability."

Crisis and Reform in the Euro Area

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In 2012, the existence of the European Monetary Union with 17 member states was under substantial threat. At the moment, the pressure has decreased. Several decisions in the second half of 2012 have calmed markets. Among them were the announcement by the European Central Bank (ECB), at the height of the crisis in August 2012, of a major bond-buying program; the launch of a permanent rescue fund, the European Stability Mechanism, in October; and an agreement by the heads of states and governments in December to create the first pillar of a banking union and to investigate steps toward a fiscal union. These measures add to governance reforms implemented in previous years.

The relief that the euro area is now experiencing may, however, prove temporary. Many, for instance Christine Lagarde, the International Monetary Fund's managing director, see 2013 as a make-it-or-break-it year for the euro area. Major risks remain in the financial sector. Doubts about the sustainability of public finances, and about the ability of member states to reverse economic divergence among them in the absence of substantial transfer mechanisms, may once again put the euro at risk. And a discouraging global economic outlook complicates the situation. Adverse market reactions to new economic and financial data, or to political developments in euro area member states or the European Union as a whole, could bring the crisis back overnight.

If market pressures rise again, further-reaching steps in crisis management and institutional integration likely will be necessary to keep the euro area together. New and profound challenges to the EU's legitimacy would compound the difficulty of implementing such steps. But even if the crisis does not re-accelerate, further reforms are needed, and these will require national policy makers and voters to rethink their positions in the debate on the future political nature of the monetary union.

RESILIENT EUROPE

Now in the fifth year after the financial crisis hit Europe, the EU and the euro area have shown a degree of resilience and flexibility that many observers and policy makers would not have predicted. While handling day-to-day crisis management, the governments of the 17 euro zone nations have made a series of decisions on institutions and governance procedures that have changed the face of the euro area quite substantially. These decisions have often been criticized as slow and insufficient, and, measured against the pace and scope of the crisis, the criticism is correct. But given the complexity of the EU's decision-making system and the manifold political, institutional, and juridical obstacles to institutional change and integration, it has to be acknowledged that the euro area has demonstrated unexpected problem-solving capacity.

Four factors explain why crisis management and institutional reform have been so intimately linked in recent years. First, the more that national governments and constituencies have realized how costly the sovereign debt crisis could prove, the greater the desire has grown to tackle root causes of the crisis so that a similar one will not occur. This concern remains particularly strong in Germany, which shoulders 27 percent of the capital and guarantees in the rescue mechanisms, and which has proposed a number of reforms since it agreed to the first bailout package in the spring of 2010. Domestic political and legal constraints and the dominance of certain kinds of economic think-

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ing further explain why the German government has pushed for tougher fiscal rules and mechanisms that pressure southern European member states to adopt structural reforms (such as labor market reforms and liberalization of service sectors) to improve their competitiveness.

Second, some of the crisis management measures have changed the euro zone's political economy. The creation of a permanent rescue instrument, the European Stability Mechanism, and the bond-purchasing programs of the ECB are seen as provoking risks of moral hazard, as some member states potentially could stop their reform process and hope for support, given their systemic relevance to the euro area. Most of the governments on the donor side of the rescue mechanisms argue that there should be more control over domestic policies and more automaticity in implementing surveillance and sanctions.

Another idea, put forward by Germany in the initial phase of the sovereign debt crisis, was to counterbalance moral hazard risks by introducing a sovereign default mechanism. The perception then was that market mechanisms could discipline governments more effectively—given the mixed experience of euro area member states in trying to exert control over each other in cooperation with the European Commission. The German proposal was shelved as markets reacted nervously to the idea of a sovereign default in the euro area. A consensus emerged, pushed mainly by the ECB, that a default could not be ring-fenced, and would substantially affect overall financial stability.

Other member governments have tried to find bilateral means for balancing the risks they are taking by handing out money to highly indebted countries. The Finnish government, for instance, asked Greece to provide direct guarantees that could be drawn upon to compensate eventual losses for Finland if Greece fails to pay back fully the credit it obtains via the European rescue mechanisms. This made a domestic ratification of the rescue measures easier for Finland, but it came at a price in the credibility of the euro area's financial solidarity.

A third reason why crisis management and governance reform have gone hand in hand lies in the bank-sovereign nexus—that is, the direct relationship between the sovereign debt and the banking crises. In some member states, most visibly Ireland and Spain, the public debt crisis was actually triggered by a debt crisis in the private sector. Moreover, it is increasingly acknowledged that high interest rates on public debt are not only a problem for governments' refinancing. They also cause higher refinancing costs for the banking sector, and for the real economy of the countries most severely hit by the crisis. A new consensus has emerged that this systemic crisis can be tackled only by a very broad set of measures, including a banking union that provides instruments to break through the bank-sovereign nexus on the national level.

Fourth, it has become clear that the sovereign debt and banking crises can be resolved only if markets believe in the euro zone's long-term survival. If there are doubts about the commitment to keeping all current members, the euro area may no longer be perceived as a currency union with the long-term advantages this entails, but rather as a system of fixed exchange rates that a member potentially could leave at any time. Soon after Greece encountered problems refinancing its debt in the spring of 2010, the affliction spread to other euro zone member states. It took on characteristics of a self-reinforcing crisis, not only due to the often blamed speculation or irrational behavior of market participants, but also because long-term-oriented investors withdrew their capital as they assumed these assets were becoming too risky. Bondholders started to price in the risk of a euro area break-up. To bring down risk premiums in this situation has required not only crisis management but also a credible long-term perspective for the euro zone.

To buttress sustainability, progress must be made in three areas. There has to be a credible "growth story," possibly including a move toward debt restructuring in several countries, which would allow the euro area to reach sustainable debt levels. There has to be a strong commitment to keeping the currency union together in its current composition, which the ECB provided with its announced bond-purchasing initiative. Finally, and what I will focus on here, there have to be reforms that not only improve the euro area's economic and financial functioning, but also address the growing problems of legitimacy.

UNDER NEW MANAGEMENT

Since the crisis hit the EU, member states have adopted a series of important measures to strengthen financial and economic governance. Only a few months after the financial crisis had spilled into Europe from the United States, work on new financial supervisory structures began. The most important innovation was the European Systemic Risk Board, which took up its work on January 1, 2011, offering macroprudential oversight of the financial system. Three European supervisory authorities—the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority—were established as well. These, however, have limited powers and rely strongly on national supervisors—a setup that seemed insufficient as the banking crisis spread.

So, not even two years later, in December 2012, the member states agreed to establish a single bank supervisor, who will have direct oversight of large banks in the euro area. When financial aid is granted to banks, moreover, the supervisor will directly supervise all of them, including smaller ones below the size threshold for European supervision. The single supervisor will also help overcome the fragmentation of the European financial markets. The previous system of national supervisors had, for instance, imposed limits on liquidity operations across borders. The ECB had to compensate for the resulting segmentation of the interbank market.

Most euro member governments can no longer credibly claim that they substantially influence growth and employment in their countries.

In the field of budgetary and economic policy coordination, the most important measure was a legislative package called "six pack," which entered into force on December 13, 2011. A core purpose was to reinforce the Stability and Growth Pact, which controls national budgetary policies. Partly because of the crisis, considerable emphasis was put on preventive action. Member states are now required to make more significant progress toward balanced budgets. An interest-bearing deposit of 0.2 percent of GDP will be imposed on noncompliant euro-area countries.

The Stability and Growth Pact's disciplinary arm also has been strengthened. The so-called Excessive Deficit Procedure can be triggered if either government debt or government deficits do not comply with the European targets. Progressive financial sanctions, in this case a non-interest-bearing deposit of 0.2 percent of GDP, can kick in at any point. And if a country fails to take corrective action, it can actually be fined.

The euro zone members, moreover, have set minimum requirements for national budgetary frameworks. Member states' fiscal frameworks have to respect minimum quality standards and cover all administrative levels. National fiscal planning should adopt a multi-annual perspective. Fiscal rules should also promote compliance with the Stability and Growth Pact's limits on deficits and debts. On January 1, 2013, the Fiscal Compact went into effect. This intergovernmental treaty compels signatories to enact laws requiring balanced budgets within a year after the compact enters into force for them.

Increasing Oversight

Also reformed are the surveillance and coordination of member states' economic policies. The new Macroeconomic Imbalance Procedure is supposed to identify potential risks early on, correct existing harmful imbalances, and prevent future ones. It is intended to ensure that member states adopt appropriate policy responses in a timely manner. If a state fails to meet its obligations, sanctions can be imposed. In March 2011, 23 EU members signed an additional, more detailed agenda for economic policy coordination, the so-called Euro Plus Pact, with the objective of boosting economic competitiveness and convergence. Concrete goals, including in areas of national responsibility, were agreed upon and are to be reviewed on a yearly basis by the heads of state or government.

Both for budgetary and macroeconomic policy coordination, enforcement has been strengthened by the expanded use of "reverse qualified majority" voting. A recommendation or proposal issued by the European Commission to the Council of Ministers is now considered as adopted unless a qualified majority of member states votes against it. This is supposed to limit a finance minister's capacity to "interpret" the rules in place. (Governments that may soon break the rules may choose not to impose sanctions on fellow governments if they fear being next in line for sanctions).

The so-called "European semester" is another important reform. The policy coordination timetable has been changed in such a way that now fiscal and economic policies as well as financial developments are analyzed and assessed together during the first half of every year, hence early enough to increase the possibility of influencing domestic policy choices. Member states hand in various reports early in the year, and the European

Commission proposes concrete policy recommendations for each country. In June, the European Council discusses the recommendations, and the Council of Ministers adopts them. Before the discussions on the EU level, governments draw up their draft budgets. Once the European semester has been completed, governments are expected to adjust policies and budgets and submit them to national parliamentary debate in the second half of the year.

All these reforms aim at streamlining domestic policies and limiting the scope of national discretion. However, the member states have stopped short of transferring sovereignty to the European level. They have opted instead for a combination of European rules and sanctions, domestic constitutional changes, and additional intergovernmental agreements. While the Eurogroup—that is, the heads of state and government in the euro area—now meets regularly at least twice a year, there is not yet a "European economic government" that would deserve this name.

The debate on banking, fiscal, and political union has indeed evolved considerably in the past year. Yet a consensus has still to be found regarding which competencies in budgetary, economic, and financial policy making should be transferred to the European level in order to stabilize the monetary union in the long run. Nor is there agreement on how democratic legitimacy for this more closely integrated union should be achieved, even if no further transfers of authority occur.

Many see 2013 as a make-it-or-break-it year for the euro area.

TASKS AHEAD

In June 2013, the European Council will discuss further steps to complete the economic governance framework for the euro area. Regarding the banking union, the reasonable next step would be to create a common bank resolution authority for orderly restructuring or liquidation of failed banks, in order to allow risk-sharing while containing moral hazard problems. Another important idea, which however currently receives little support in member states with stable banking sectors, is a European bank deposit insurance scheme. These forms of risk sharing in the banking union would help break through the vicious bank-sovereign nexus described above. Such a full-fledged banking union would in turn require progress toward fiscal union, since it would entail important elements of cross-border financial solidarity. This provokes questions of legitimacy and democratic accountability.

It is notably in the delicate area of fiscal and economic union that less progress has been made. While EU oversight of national fiscal policies has been strengthened, a substantial limit on national sovereignty, for instance if a member state continues to break European rules, has not been agreed upon. Germany has, for example, suggested a withdrawal of voting rights in the European Council if a member state violates the rules and ignores policy prescriptions.

The focus on overseeing national fiscal policies reflects the initially rather narrow interpretation of the sovereign debt crisis as resulting mostly from irresponsible budgetary policies. Now it is more and more acknowledged that the euro area may need more macroeconomic instruments at its disposal. Since members have handed monetary and exchange rate policy to the ECB, macroeconomic developments are more or less a random result of national policy decisions. The interest rate set by the ECB, which takes euro area averages into account, has come to be a one-size-fits-none rate, as cyclical divergence has grown amid insufficiently functioning markets and in the absence of fiscal transfer mechanisms.

A major task now is to enable long-term economic convergence. Part of this problem may be addressed with increased cross-border flexibility of labor, capital, and services markets. In addition, a euro area budget could help achieve structural and cyclical convergence. A major step forward would be the introduction of automatic stabilizers. This could, for instance, take the form of European unemployment insurance, similar to the federal unemployment scheme in the United States. The European Commission and the French government are currently working on such proposals. Some form of mutual guarantee for public debt could also be important to contain future crises of confidence. However, if euro bonds were introduced, this would in parallel require even closer control of national budgetary and economic policy decisions in order to manage the risk of moral hazard.

IMPROVING LEGITIMACY

These suggestions imply far more than a technical fix to the incomplete architecture of an economic and monetary union still in the making. Implementing them would entail giving substantially new responsibilities to the European level, which would have to be legitimized by referenda in a number of member states. A major challenge for policy makers lies in the fact that they may have to move forward with a deepening of integration at a time when the EU and the euro area confront a growing crisis of acceptability. It is difficult to argue for deepening a monetary union that more and more citizens have singled out as a key reason for the economic and social difficulties they are facing. This is particularly so for the member states that have received money from the European rescue funds and the IMF and have had to implement strict conditions for the lending.

Many Europeans today see economic and in particular financial openness as having destabilizing political effects. More than globalization, the single market and the euro limit governments' ability to control economic developments at home. They also have increased the pressure on nations to become more competitive. Monetary and financial market integration has introduced a bias toward supply-side policies at the national level in order to attract investment and corporations that are tempted to move to sites with lower taxes and production costs. Until the sovereign debt crisis hit the euro zone in early 2010, low interest rates in the less competitive and less fiscally sound member states hid these new constraints and enabled unsustainable choices by the political and financial elite. Since markets have switched to an over-emphasis on country risk, these same governments have been exposed to severe constraints, and the immobile segments of their economies and societies bear the adaptation costs.

Today, most euro member governments can no longer credibly claim that they substantially influence growth and employment in their own countries. Intensified European and global competition pushes them to reduce tax-financed welfare spending and to review employment regulation and production conditions. Unions have to accept lower wages and less attractive employment conditions to keep jobs in the country.

Yet redistributive welfare and taxation policies and a considerable degree of social security helped build the foundation for stable democracies in the postwar period. Given the intimate connection between the European postwar concept of liberal democracy and the welfare state, the erosion of state capacity to provide social security and regulation may undermine the stability of national democracies. First indicators that this could happen are rising populism, even extremism, and a growing skepticism toward the EU and globalization in a number of member states.

For the time being, the EU has not revealed itself politically as the place where at least partial remedies to these problems can be found. If this remains the case, economic inefficiencies, the slow erosion of the welfare state, and rising inequality will seriously delegitimize the EU and national governments along with it. This should be reason enough to explore how the currency union's governance can be made more democratic.

A EURO AREA PARLIAMENT?

A path-breaking decision would be to install a euro area parliament that would handle the euro zone budget, together with the member states, and that could adopt an area-wide aggregate fiscal stance. This would have the advantage of actually bringing back macroeconomic policy choices to the euro area. Meanwhile, decisions over income and expenditure policies could remain on the national level. Composed of members of the European Parliament from euro area member countries, a euro area parliament could also play an important role in the surveillance and supervision of the banking union and rescue mechanisms. It could also oversee a European executive, which could be developed out of the European Commission. A quantum leap would give the euro area parliament the right to raise taxes and a say in the design of the automatic stabilizers that the currency union needs.

Given the reality of sectoral and political interdependencies, the case for a further deepening of the euro area is strong. All governments will face tough trade-offs as they work on these issues in 2013 and beyond. Integration has already reached such a depth that further steps toward a fiscal, banking, or political union entail transfers of responsibilities to the euro area level that may be seen as undermining national sovereignty. Moreover, making the euro area more crisis-resilient implies more risk sharing and solidarity, which is difficult to sell to national constituencies. This is why part of the challenge the euro area governments face is to engage in a broad public debate on the benefits of the euro and the costs of its dissolution. ■