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Discussion Paper
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Malfunction of the Economics: Debt Crisis and the Future of European Integration

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I. European Debt Crisis and the Economics

The so-called European debt crisis, in the strict sense, is neither a debt crisis of Europe nor of the EU but a sovereign debt crisis of the Euro zone countries. We might remember Robert A. Mundell, the Nobel Memorial Prize Laureate in Economic Sciences in 1999, who has built the OCA (Optimal Currency Area) theory in 1961. According to this theory, when economic factors including labor, capital, goods and services flow unrestrictedly among certain areas (countries) and are excluded by others, those areas with liquidity will constitute an optimal currency area, in which different countries share the same currency. The advantage of forming a monetary union lies in several aspects: 1) to reduce transaction costs; 2) fixed exchange rate or single currency could mitigate the impact of uncertainty in development of the regional economy, and eliminate speculative capital flows among union members; 3) A monetary union could foster integration of economic policies in the region. Soon afterwards, other economists such as Ronald McKinnon, P. B. Kenen and James Ingram further developed the OCA theory proposed by Prof. Mundell, ultimately shaping a complete theoretical system of optimal currency in the economics. It is thus undoubted that both the birth of Euro and the formation of Euro zone are based on OCA theory. Prof. Mundell could also live up to the name of “Father of Euro”. However, today’s European debt crisis causes us to think more about the OCA theory. Does this popular economic theory really make any sense?

Before laying out more details on the European debt crisis, it is necessary to have some knowledge about the case of Long-Term Capital Management L. P. (LTCM), a US hedge fund whose board of directors members include Myron Scholes and Robert C. Morton, who shared the 1997 Nobel Memorial Prize in Economic Sciences for a new theoretical method to determine the value of derivatives. Founded in 1994, the firm was initially successful with guidance of the above method in its first years, while in 1998, it lost $4.6 billion in less than four months following the Russian financial crisis, leading to a bailout by other financial institutions, under the supervision of the Federal Reserve. Therefore, it is evident that economic theories, models or methods of the two Noble Prize-winning economists are not absolutely free from loopholes in practice.

History always repeats itself. In 1986, the European Community (EC) member countries signed the Single European Act (SEA), aiming at completing the internal market in EC with free flow of people (labor), capital, goods and services. The internal unified market was finally created in 1992, soon after the end of the Cold War. Under these circumstances, European monetary integration was put on the agenda according to Prof. Mundell’s OCA theory, which culminated in the birth of the EURO in 1999 and its circulation in 2002. We had assumed that the birth and circulation of Euro could definitely reduce transaction costs, speed up capital flow,

and make the price of goods and services more transparent, all of which would contribute to develop a more economically competitive Euro zone. More importantly, European integration with effect of Euro could step forward in the direction of establishing a super-state or European federation, just as the OCA theory has predicted. In this way, the European Union (EU) was likely to become another superpower like the US, while the Euro could also become another strong currency like the US dollar.

From the perspective of market development, Prof. Mundell's OCA theory is correct—the region with transnational flows of economic factors could benefit most from currency integration. Nevertheless, we should not forget the fact that currency integration is not a purely economic issue, only determined by market rules, but also a political decision. The birth and development of Euro zone depend more on those EU member countries who decide to join than on market rules. Obviously, neither Prof. Mundell nor his followers paid enough attention on the role of each EU member country in the process of shaping the Euro zone. Actually, EU politicians and monetary experts have formulated the standards of joining the Euro zone for its member countries long before the birth of the Euro, and adopted the Stability and Growth Pact (SGP) in 1997. According to the SGP, member countries who want to join the Euro zone must respect the following two criteria: 1) an annual budget deficit no higher than 3% of GDP the same year; 2) a national debt lower than 60% of GDP or approaching that value. Member countries who fail to meet these criteria will be blocked from the Euro zone or take economic punishment. Nonetheless, EU member countries willing to join the Euro zone could be able to violate the above criteria in the name of sovereignty, since each EU member country is a sovereignty state. Let's take Greece as an example. In order to join Euro zone, Greece has used national power to meet the standards, making fake accounts through transactions of Goldman Sachs. On the other hand, Euro zone countries who intended to deepen European integration by pushing forward the enlargement of the Euro zone, also turned a blind eye on the qualifications of Greece as well, which planted the seeds of European debt crisis.

If we try to find the root causes of the crisis, we would see some flaws in the design of Euro system. In my opinion, the most fundamental problem is the inconsistency between fiscal policy and monetary policy. Since the Euro has come into being, Euro zone countries have handed the responsibility of making monetary policy to the European Central Bank (ECB), while still reserving the power of making their own fiscal policies. That is to say, Euro zone countries could not take monetary measures in adjusting their economic policy. The active adoption of fiscal policy would be thought of as a violation to SGP, and in our mind, those who go beyond the limit to increase the budget deficit were countries like Greece. However in fact, it was Germany and France that first violated the SGP and set bad examples for Greece, Portugal and Republic of Ireland etc. To

stimulate their own economic growth, Germany and France increased their annual budget deficit to a level higher than 3% of GDP in 2002 and 2003, and successfully escaped punishment through various kinds of means.

As each Euro zone country has its independent fiscal policy, lacking the system of transfer payment, any country in fiscal difficulty is unlikely to find a solution through a transfer payment system. There is no central government or federal government in the Euro zone. It is hard to imagine a sovereignty country would offer to bailout to another sovereignty country. As a matter of fact, Greece only accounts for 2% of EU GDP. Even though Greek public debt hits 165% of GDP (the figure is much lower in 2009), I think another Euro zone country--Germany would have been fully capable of bailing out Greece. Unfortunately, Germany did not take such action for lack of a transfer payment system, missing the best chance to prevent Greek debt crisis from developing into a large-scale one. Germans were reluctant to see their government spend taxpayers' money to back Greece.

What Prof. Mundell and his followers had neglected also included social and cultural factors in the Euro zone. It is easy to find some cultural differences in Europe, and people from different part of the continent usually have divergent customs. South Europeans like Greeks and Portuguese prefer a life of leisure while North Europeans like Germans and Dutch are more serious, rigid and passionate about their work. Not too long ago, I paid a visit to Sweden, an EU member state outside the Euro zone. I was told by Swedish scholars that Sweden was much more qualified for joining Euro zone considering its general economic level and cultural background. However, Sweden would not choose to become a Euro zone member according to its historical experience. From his point of view, Greece and other South European countries should not have joined the Euro zone, for their general economic level could not meet the standards in contrast with Sweden, and culturally, they are too random to comply with any fiscal discipline. So in this sense, the European debt crisis seems unavoidable.

From late 2009, fears of a sovereign debt crisis developed among investors as a result of rising private and government debt levels around the world together with a wave of downgrading of government debt in some European states, typically the PIGS (Portugal, Ireland, Greece and Spain) and then PIIGS (Portugal, Ireland, Italy, Greece and Spain). In Greece, unsustainable public sector wage and pension commitments drove the debt increase. The structure of the Euro zone as a monetary union without fiscal union contributed to the crisis and impacted the ability of European leaders to respond. Concerns intensified in early 2010, leading Europe's finance ministers in May 2010 to approve a rescue package worth €750 billion aimed at ensuring financial stability across Europe by creating the European Financial Stability Facility (EFSF). At the same time, the Greek government announced a series of austerity measures to secure a 3-year €110 billion loan. In November 2010, the Ireland government received €85 billion

bailout money from EU, ECB and International Monetary Fund (IMF), and in May 2011, Portugal also got a €78 billion bailout package. To prevent Greece from withdrawing the Euro zone, EU, ECB and IMF eventually agreed in February 2012 to provide a second bailout package worth €130 billion, conditional on the implementation of another harsh austerity package, which was met with great anger by the Greek public, leading to massive protests, riots and social unrest throughout Greece.

II. The Impact of Debt Crisis on European Integration

Today, the European debt crisis is an ongoing financial crisis that has made it difficult for some countries in the euro zone to refinance their government debt without the assistance of third parties. What's the impact of this crisis on EU and European integration? I think it has shown some true colors of the EU and European integration. The EU is always regarded as an important pole in the contemporary international system by political elites as well as intellectuals. As a new actor in the system, the EU has almost turned into a super state or an ultra state like other world powers. Large numbers of scholars and even politicians in Europe hold the opinion that the EU, with the deepening of European integration, is developing toward a European Federation, or at least European Confederation. However, the ongoing debt crisis and the reactions of EU and Euro zone members remind us that it may be too early to come to such conclusion.

I once wrote an article in 2007 to discuss whether EU is a world power. My answer is negative. In my mind, The European Union, from the 1957 signing of Treaty of Rome, has been a regional intergovernmental organization (IGO), while its members such as Britain, France, Germany and Italy are real powers. So in the strict sense, the EU shares same characteristics with the North American Free Trade Area (NAFTA), the Association of South East Asian Nations (ASEAN), The League of Arab States (LAS), the African Union (AU) and the Shanghai Cooperation Organization (SCO). The only difference of the EU lies in its higher level of integration. Although the EU does indeed have a strong will to develop into a super state or federation, it is not a real world power like big sovereignty states but a special non-state actor in our international system.

Some scholars in European studies consider the debt crisis a good opportunity to get the EU transformed into a more integrated pole in the current international system. Institutional arrangements for Euro zone countries include the temporary EFSF and then the permanent European Stability Mechanism (ESM) with a rescue funding program of €700 billion. More importantly, EU member states, after long negotiations, signed the Fiscal Compact (formally, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) at the EU summit in March 2012, which was a vital step in the process of building a

European fiscal federation and also laid the foundations for dissolving the inconsistency between a unified monetary policy and divergent fiscal policies.

Nevertheless, the Fiscal Compact is still intergovernmental instead of covering all EU members. Great Britain and the Czech Republic, for their own sake, did not join the treaty at all. In this case, the Fiscal Compact could be a double-edged sword to promote and undermine the process of European integration. While in other cases, any EU country might follow in steps of Great Britain and the Czech Republic. To achieve the goal of becoming an ultra state or federation, the EU still has a long way to go. European integration will be an ongoing process with multi-speed development in the future.

The nature of European integration revealed by the Euro debt crisis will cause Chinese IR scholars and political elites to re-think the role played by the EU in current international system. Although up until now the main stream in China's IR academic circle and in foreign policy decision making circle is still maintaining that the multi-polarization is the main contemporary world trend, it seems hard for them to persist in considering that the EU is still an influential pole in the current international system. In contrast, during the process of the Euro crisis the big member states like Germany, United Kingdom, and France have behaved as great powers in terms of handling international as well as European affairs. Although the European integration process will not stop because of the crisis, the European dream seems not that easy to be realized in the near future. All these facts will have great impacts on the China-EU comprehensive strategic partnership. While China continues to attach the importance to the EU as a global player it will think much of Germany, UK, France, or even Poland as real powerful players, which means Beijing will keep phoning Brussels as her strategic partner but before that Berlin, London, Paris and Warsaw may be have already called.