Patterns, Challenges, and Strategic Choices in the Euro Crisis

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At the time of writing it is close to the 20th anniversary of the European Council meeting that negotiated the Maastricht Treaty and laid the legal foundations for European Monetary Union (EMU). The relevance of recalling this is evermore pertinent as Germany seeks to get the European Council to agree 'Maastricht Plus': that is, economic and fiscal union to parallel monetary union. Above all, however, the final weeks of 2011 are a time in which the Euro Area faces both extreme danger and historic opportunity. The scenarios are: risk of disorderly sovereign defaults, bank failures, and implosion of the Euro Area; a risk that the EU will try to continue muddling through with an unsustainable status quo which is lacking credibility; and pushing ahead with transformation into a fiscal and economic union. The EU faces a 'leadership call', as it did in 1991 when Chancellor Helmut Kohl committed Germany to irreversibility of EMU.

The outlook for the next decade is bleak:

- A more differentiated Europe as the price of accelerating union
- Stagnant, even declining living standards
- A 'lost generation' of young people
- Fertile ground for populist and extremist parties to hunt for scapegoats and votes.

The Context

Crisis in the Euro Area, the EU and the UK is enmeshed in an evolving global and European financial and economic crisis. Its dimensions are profound: historical and structural.

Firstly, this is a crisis of an unsustainable economic model of debt-fuelled growth, rooted in a naïve belief in self-correcting markets that need no more than a light touch of supervision and regulation. The huge challenge is how to restore growth (in order to pay off debt burdens) without incurring more debts or resorting to runaway inflation. Hence, we are living through a paradigm shift in economic thinking.

Secondly, the crisis reflects shifts in the tectonic plates of European and global politics. In this respect it invites comparison with post-1914, with post-1945, and with post-1989. Each of these periods generated profound shifts in both the relative power of Europe, and the relative power within Europe. It is a crisis of the Atlantic world rather the emerging markets; it is accelerating a global shift of power to Asia; and, not least, it represents a new 'Gilded Age' of extremes of wealth and income in which the legitimacy of market and political power is open to new more serious challenges.

As the tectonic plates move, the weaknesses of both the EU and its Member States are thrown into bold relief. Their ambitions to shape globalization are not matched by adequate policy instruments to meet these challenges. The political drive for integration is not flanked by a policy capacity to tame markets in the larger public interests of securing the financial stability of the EU – and ultimately its very survival.

Thirdly, the evolving crisis is serving as a litmus test of domestic ownership by governments, elites and publics of European integration. This lack of ownership over the first decade of the common currency has grievously wounded the Euro Area's credibility. Are governments prepared to take responsibility for what needs to be done to stabilize the European economy and put it on a sustainable basis? Are they willing to act boldly?

Where Does the Euro Area Stand?

Comparative data on the UK and the Euro Area in the financial crisis since 2007/2008 shows the UK under-performing the Euro Area on economic growth, inflation, current account, competitiveness measured by unit labour costs, and fiscal deficit – with a projected structural deficit worse than Greece, Portugal, Spain and Italy. The only favourable indicator for the UK is public debt, where the UK is 5.5% below the Euro Area. However, the UK benefits from lower bond yields as it issues bonds in its own currency and thus can resort to instruments, like devaluation and printing money – which are denied to Euro Area members. The credibility problems of some Euro Area states are compounded by deficiencies in Euro Area institutional design and the legal basis of economic governance. There is the lack of fiscal and political union to parallel monetary union: no collective responsibility for debts, no Eurobond issuance, only weak collective action capacity to correct excessive imbalances and to address macro-prudential regulation of banking. Above all, there is lack of deterrence capability in the form of legal capacity to act decisively in 'supreme emergency' when the danger to the community is 'close and serious', its very existence threatened. The fact that the US only gained this capacity well over a century after its foundation is little consolation.

The Nature of the Crisis

The EU faces a compound financial, economic and structural crisis of huge scope, depth and reach – unparalleled since the 1930s. It is fast becoming a crisis of both states and the EU. Until now it has been 'a tale of two crises':

(1) The financial crisis beginning in 2007-08 with Bear Stearns, Northern Rock, RBS, HBOS, above all Lehman. This was the phase of Anglo-American crisis, in which the EU had a 'better crisis' than the USA. In this phase the UK was pace-setter at global, EU and even Euro Area levels in bank recapitalization and in reinvigorating G20. The UK made friends.

(2) From late 2009 the phase of sovereign debt crisis. This affected both the UK and Euro Area, and initiated a new phase of fiscal austerity. In this phase the EU and Euro Area had a bad crisis; the UK stood aside, no longer a pace-setter in the sense of uploading its ideas to the EU and Euro Area level. UK domestic politics has been caught between contending pressures, faces difficult strategic choices, and has limited leverage. There is a new, currently sharpening climate of anxiety, suspicion, and distrust between UK and other EU capitals and institutions.

What Does History Show?

More than one hundred years of history have shown that crises of this type are long-term – 10 years at a minimum – and unfold in unexpected, sometimes dangerous ways. We are just 4 years into what may be a tale not of two but three, four or more crises. The UK is locked into long-term austerity as the government, banks and households simultaneously de-lever. The risk is that, if the crisis unfolds into a UK crisis, the UK might find itself with fewer sympathetic friends than it had in 2007-08. A rule of crisis management in this context might be to take out insurance – to accumulate credit, trust and respect now in case of worsening times. With that point in mind, it is worth asking ourselves; is the UK insuring itself adequately for the longer term?

Gaps in Legal and Political Thinking

The Euro Area sovereign debt crises point to a fundamental gap in legal and political thinking about the EU. For very good reasons of history and of legitimacy, lawyers – especially German – have placed prime weight on honouring Treaty commitments, notably to the 'no bail-out clause' and 'no privileged access of governments to the central bank'. These are fundamental principles of the Maastricht monetary constitution. After 1933, German lawyers have been deeply averse to endowing governments with emergency powers. However, the basic question arises of whether, when the context in which a Treaty was made *changes*, all bets are off.

Member State governments are politically committed as a matter of existential national interest to making the euro work, to ensuring its survival, and to 'do what has to be done' to ensure that banking collapses and disorderly sovereign defaults do not trigger the collapse of the euro and risk the breakup of the EU. This requires ultimately that the Euro Area has the capacity to act in 'supreme emergency': that is, when the danger to the community is 'close and serious', when the Union's very existence is threatened. Such situations place it under 'the rule of necessity (and necessity knows no rules)' (Michael Walzer, *Just and Unjust Wars*, 1992: 254). Extreme circumstances reveal the ultimate rigidity in treaty law and the need for some legal box to provide ultimate insurance. We are talking about a 'supreme emergency exemption' from the no-bail out clause. There has to be a 'lender of last resort', armed with the firepower to restore confidence to markets in extreme circumstances. The question of who is significant but secondary. Reliance on the ECB to act in this role has the disadvantage of mixing fiscal and monetary policies and creating alarm about inflation. However, its key advantage is that the ECB – unlike other alternative candidates – would have an institutional self-interest in disengaging from this role early once 'warning lights' had dimmed. It would also be well-versed in central banking practices of 'constructive ambiguity'.

However, accepting, creating and acting on this basis raises difficult and fundamental questions of legitimacy, legality and consent. In answering these questions, one must ask: 'What ultimate claim to legitimacy can the EU make in the absence of a capacity to act in a 'supreme emergency?' Perhaps the starting point would be to return to the legal and political status, and implications, of 'irreversibility' as insisted on by Chancellor Kohl of Germany in December 1991.

The Tension between Sovereignty and Solidarity

The crisis reveals in sharpened form the tension between solidarity and sovereignty. Member state governments, notably France, have acted to defend claims to fiscal sovereignty and to confine crisis management to the intergovernmental rather than the supranational or Community method. In doing so, they have sidelined the Commission and the European Parliament in favour of the European Council. The lessons of the crisis were twofold: firstly, that the intergovernmental method is unsuited to the requirements of urgent, decisive action in crisis; and, secondly, the misfit between the speed of markets and of Council decision making. There is a problem of 'inter-temporal inconsistency'.

Governments proved unwilling to invest the European Commission with supranational authority in fiscal surveillance and monitoring and in correcting excessive imbalances. They fettered the discretion of the European Financial Stabilization Facility (EFSF). There was unwillingness in key quarters to envisage a 'lender of last resort'. The crisis generated much appeal to 'solidarity' but no agreement on what it entailed. The Germanic conception of 'solidarity as effort' triumphed over the conception of 'solidarity as collective assistance'. This was reflected in hostility to transforming the small EU budget into a bigger macro-economic instrument for stabilization, to Eurobonds and, more generally, to the assumption of collective responsibility for public debts. Domestic efforts to achieve 'convergence' had primacy.

Power Realities of the Crisis

The crisis serves to reveal underlying power realities of modern Europe. It brought creditor state power to the fore. This is exemplified in the core role of Germany as arbiter of what is politically and legally desirable and feasible, reinforced domestically by the mutually complimentary veto roles of the Bundestag and the German Federal Constitutional Court. It also showed the loneliness and anxieties that beset Germany as the self-assigned 'stability anchor' of the Euro Area, the ultimate guarantor of its creditworthiness.

German loneliness derived from the larger number of debtor than creditor states. Germany also feared contagion into its banking system and sovereign debt ratings from assuming liabilities; it was anxious about the implications of its responsibilities for its own creditworthiness. In addition, German power induced external resentment and resurfacing of negative historic images, notably in Greece. German leaders feared being misunderstood. These anxieties and loneliness shaped German negotiating strategy:

- To pursue coordinated positions of the 6 triple-A rated Member States, especially with Finland and the Netherlands.
- To invest heavily in the Franco-German relationship both for historical symbolism and because they accounted for nearly 50% of Euro Area GDP. By 2011 the term 'Merkozy' had been coined to describe this central axis of power.
- To seek to downplay signals of asymmetry of power in this core relationship
- To seek cover for creditor power in the role of the so-called 'Frankfurt Group'.

Above all, Germany brings to negotiations a narrow domestic 'win set' of options that it can ratify. It also has an intellectually coherent narrative of the crisis rooted in economic principles, clearly assigning blame to others for 'living beyond their means'.

Strategic Options for the UK Government

The UK government' strategic options are fourfold:

Firstly, to stay aloof and play the honest broker, as it did in negotiating EMU during the 1990s – in this case helping as an impartial player to broker agreements on closer fiscal and economic union (Dyson and Featherstone, *The Road to Maastricht*, 1999). This option has the gains of retaining, even making, friends. Negatively, it means that the outcome will be a relegation of the UK to the margins of Europe. Realistically, this strategy lacks credibility because of the scale of Euro-scepticism inside the government majority, which creates an incentive to 'hector' the Euro Area, to define negotiations in zero-sum terms, and to claim victories.

A second strategic option is to use the crises in the Euro Area to assign blame for UK economic performance away from the UK government. This option promises domestic electoral gains if the public is persuaded by this narrative. Negatively, it means adding fuel to populist Euro-scepticism; it also means losing trust and respect across Europe; and it risks putting the continuance of the coalition government between the Conservatives and the Liberal Democrats to the test.

The third option is to see the crisis as an opportunity to rebalance the UK's relationship with the EU in exchange for support on Treaty change. This option might work in employment and labour-market law (with German support). Negatively, it faces the risk that Euro Area governments, plus others wishing to join them, go outside the Treaty of 27, isolating the UK even in the issues that matter most, like the Single Market and financial services legislation. Seeking to use renegotiation and a UK referendum as leverage would induce the others to leave out the UK.

The fourth strategic option is to seek to lead an alternative 'euro outsiders' group. However, this lacks shared interests when a number are keen to enter the Euro Area or at least wish to be closely alongside France and Germany. Also, this grouping accounts for less than 25% of EU GDP (of which the UK accounts for 13.8%).

In reality, UK leverage is limited. For this reason, the government faces a political dilemma. If the UK ups its price for agreement on economic governance reforms, France and Germany will go outside the EU treaty system, and the coalition might be at risk. If the Prime Minister ignores 80+ Conservative Party backbenchers who defied his three-line whip, he risks becoming isolated within his own party.

Additionally, there is no unified block of euro outsiders that the UK can lead. Most wish to join the euro sooner or later and, other than Denmark, are legally obliged to pursue entry.

The best option seems to be to court German interest in building coalitions of economically liberal EU Member States. However, even here leverage is limited by the different nature of German Ordo-liberalism from UK market liberalism. German thinking is focused much more on putting in place a firm framework of rules (and thus order) within which markets must operate, exemplified in different attitudes to financial services regulation.

Conclusion

In sum, the Euro Area crisis reveals the tightening limitations of UK negotiating power. It raises the stakes in European integration to new heights, along with the incentives to move ahead by differentiated integration in reforms of economic governance, tax and other policies. It also invites political populism and extremism in the search for scapegoats and for the revival of negative historical stereotypes.

The crisis also highlights the scale of the UK financial and economic crisis compared to the crisis experienced by the core of the Euro Area, especially Germany. More importantly, it highlights the lack of soft power the UK wields due to the imbalances in its domestic economy – especially via the dependence on housing, financial services, and consumption – and the extremes of wealth and income that the British social model produces.

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