THE POLITICS OF

EUROPEAN

INTEGRATION

ANDREW GLENCROSS

Wiley Blackwell

About the website

This book has a companion website containing a range of resources created by the author for students and other readers using this book. Features include:

- Web resources
- Web links for additional resources on the EU
- Flashcards
- Independent study questions
- Consolidated glossary
- Consolidated references
- Consolidated further readings

You can access these resources at: www.wiley.com/go/glencross

The Politics of

European Integration

Political Union or a House Divided?

Andrew Glencross

WILEY Blackwell

Contents

List of Figures xi

List of Tables

List of Timelines

List of Boxes

Acknowledgments

Introduction

PART I THE HISTORY OF EUROPEAN INTEGRATION

I The Idea of Europe: Foundations and Justifications for Unity

1.0 Introduction: What and Where Is Europe?

1.1 The Historical Background to Thinking about European Unity

1.2 Early Ideas and Pioneers of Unity

1.2.1 William Penn

1.2.2 Abbot Saint Pierre

1.2.3 Immanuel Kant

1.2.4 Aristide Briand

1.3 The Peace or Civilizing Justification for Unity

1.4 The Prosperity Justification for Unity

1.5 The Strengthening State Capacity Justification for Unity

1.6 Concluding Summary

2 The Institutional Development of European Integration, 1945-1973

2.0 Introduction: Uniting for Peace

2.1 The Struggle to Resolve Post - War Security and Economic Issues, 1945-1951

2.2 The Creation of the European Coal and Steel Community (ECSC) in 1951

2.3 The Functioning of the ECSC and the Attempt at Full Military and Political Union, 1951-1957

2.4 The Continuing Pursuit of Economic Integration: Creating the EEC, 1957

2.5 Overcoming the First Tests: The Common Agricultural Policy and the Empty Chair Crisis, 1957-1973

2.5.1 The launch of the Common Agricultural Policy

2.5.2 The empty chair crisis

2.6 Concluding Summary

3 The Institutional Development of European Integration, 1973-2010

3.0 Introduction: The Widening and Deepening of European Integration

3.1 Living with the First Enlargement Round and Preparing for the Next, 1973-1986

3.1.1 Mediterranean enlargement and strengthening democracy

3.1.2 The British budget contribution dispute

3.2 Completing the Single Market as a Prelude to Monetary and Political Union, 1986-1992

3.2.1 French, German, and British perspectives on the SEA

3.3 Designing European Unity for the Post Cold War Era, 1992-2004

3.3.1 Negotiating the Maastricht Treaty, 1992

3.3.2 Preparing for a new enlargement

3.4 From Constitutional Failure to the Lisbon Treaty,2004-2010

3.4.1 The Constitutional Treaty, 2004

3.4.2 The Lisbon Treaty, 2009

3.5 Concluding Summary

PART II ANALYZING INTEGRATION

4 The EU's Institutional Dynamics

4.0 Introduction: The Functioning of the EU

4.1 An Overview of the Dynamics of EU Policy-Making

4.2 The Ordinary Legislative Procedure (OIP)

4.2.1 The role of the Commission

4.2.2 The legislative institutions: The Council of the EU and the European Parliament

4.3 The Role of Interest Groups and Experts

4.3.1 Assessing the influence of interest group lobbying

4.4 The Commission's Watchdog Role and the Importance of the CJEU

4.4.1 The development of the Court of Justice's powers

4.5 Special Provisions for Foreign Policy

4.5.1 The legal basis and decision-making structure of EU foreign policy

4.6 Concluding Summary 106

5 EU Policy-Making in Action: Major EU Policies

5.0 Introduction: The EU's Major Policy Areas

5.1 The EU Budget

5.2 The Euro

5.2.1 Preparing for European Monetary Union

5.3 The Single Market

5.3.1 Pursuing deregulation or negative integration

5.3.2 Pursuing re-regulation or positive integration

5.3.3 The single market as a work in progress

5.4 Social and Environmental Policy

5.4.1 EU environmental policy

5.5 Justice and Citizenship

5.5.1 Immigration, border control, and citizenship rights

5.6 Enlargement

5.6.1 Conditions placed on admitting new members

Concluding Summary

6. The EU in Comparative Perspective

6.0 Introduction: Why Compare?

6.1 The EU Compared with Federal States

6.1.1 Why depict the EU as a federation?

6.1.2 Explaining EU Politics using Federalism

6.2 The EU Compared with International Organizations

6.2.1 The absence of reciprocity or the *quid pro quo* principle in the EU

6.2.2 Explaining why the EU has integrated more

6.3 The *sui generis* Interpretation

6.3.1 Three facets of EU uniqueness

6.3.2 Explaining why European integration looks unique

Concluding Summary

PART III DEBATING THE EU SYSTEM AND ITS POLICY OUTPUTS

7 EU Internal Policies: The Theory, Practice, and Politics of Regulation

7.0 Introduction: Regulatory Outputs and EU Politics

7.1 Regulatory Theory and European Integration

7.1.1 Regulating against market failure

7.1.2 The debate over how to regulate

7.2 EU Regulation in Practice

7.2.1 Deregulation in practice

7.2.2 Regulating for common standards and its effectiveness

7.3 Not Just a Regulatory State: The Politics of EU Regulatory Outputs

7.3.1 The politics of deregulation

7.3.2 Balancing winning and losing sides in regulatory outputs

7.3.3 How political preferences influence regulatory outputs

7.4 Theorizing EU Regulation and Explaining Its Effects

7.4.1 Explaining the growth of EU regulation

7.4.2 Theorizing the consequences of EU regulation

7.5 Concluding Summary

8 The Institutionalization of EU Foreign Policy and Debates over the EU's International Role

8.0 Introduction: What Is at Stake in Understanding EU Foreign Relations?

8.1 The Institutions and Institutionalization of EU Foreign Policy

8.1.1 The Common Foreign and Security Policy and the Common Security and Defence Policy

8.1.2 Building capacity

8.2 The Debate over EU Foreign Policy Effectiveness

8.2.1 The Transatlantic dimension

8.2.2 Finding consensus

8.3 The Ideological Debate over the Aims of EU Foreign Policy

8.3.1 The EU as a normative power?

8.4 The Explanatory Debate over EU Foreign Policy

8.4.1 Power and interests as explanatory factors

8.4.2 Identity as an explanatory factor

8.5 Concluding Summary

9 What Model for Uniting Europe?

9.0 Introduction: Competing Models of European Integration

9.1 Federalism

9.1.1 Problems with the federal vision

9.2 Confederalism

9.2.1 Proposals for more confederalism in the EU

9.3 The Networked Governance Model

9.3.1 Concerns about legitimacy and effectiveness

9.4 The Differentiated Integration Model

9.4.1 Differentiation to allow some countries to integrate more

9.5 Concluding Summary

PART IV DEMOCRACY AND INTEGRATION

10 Democracy in the European Union

10.0 Introduction: More Integration, More Democracy?

10.1 Democratic Accountability in the EU: Beyond Majoritarianism

10.1.1 Accountability without majoritarianism

10.2 The Democratic Deficit Debate

10.2.1 The procedural critique of EU democracy: A lack of responsiveness to citizens

10.2.2 The normative critique of EU democracy: The narrowing of political alternatives

10.2.3 The case against a democratic deficit

10.3 Enhancing Democracy in the EU

10.3.1 Adding parliamentary or presidential features

10.3.2 Developing transnational parties and enhancing indirect accountability

10.3.3 Obstacles to enhancing EU democracy

10.4 Concluding Summary

11 The Impact of European Integration on National Politics

11.0 Introduction: Political Adaptation to European Integration

11.1 European Integration and National Politics: The End of the Permissive Consensus

11.1.1 The emergence of a ‘constraining dissensus’

11.2 Euroskepticism and Its Varieties

11.2.1 When and where euroskepticism is expressed

11.2.2 Hard euroskepticism

11.2.3 Soft euroskepticism

11.3 National Referendums on EU Issues

11.3.1 Why hold referendums?

11.3.2 The Political dynamics of referendum campaigns

11.4 Concluding Summary

12 Integration **and Democracy in the Shadow of the Eurozone Debt Crisis**

12.0 Introduction: The Eurozone Crisis as a Challenge to Democracy and Integration

12.1 The Causes of the Eurozone Crisis

12.1.1 Benefits and concerns surrounding the European Monetary Union (EMU)

12.1.2 The global financial crisis' effect on the Eurozone

12.2 The Travails of Formulating an EU Response

12.2.1 Deciding whether to provide a bailout and on what terms

12.2.2 The Fiscal Compact and moves toward a banking union

12.3 Criticism and Controversies Surrounding the EU Response

12.3.1 Democratic decision - making?

12.3.2 The right response?

12.3.3 Who is to blame?

12.4 Conclusion: What the Crisis Means for the Future of Integration

Index

12

Integration and Democracy in the Shadow of the Eurozone Debt Crisis

Contents

12.0 Introduction: The Eurozone Crisis as a Challenge to Democracy and Integration

12.1 The Causes of the Eurozone Crisis

12.1.1 Benefits and concerns surrounding the European Monetary Union (EMU)

12.1.2 The global financial crisis effect on the Eurozone

12.2 The Travails of Formulating an EU Response

12.2.1 Deciding whether to provide a bailout and on what terms

12.2.2 The Fiscal Compact and moves toward a banking union

12.3 Criticism and Controversies Surrounding the EU Response

12.3.1 Democratic decision-making?

12.3.2 The right response?

12.3.3 Who is to blame?

12.4 Conclusion: What the Crisis Means for the Future of Integration

Learning Objectives

- to identify structural problems with the design of EMU;

- to analyze the impact of the 2008 global financial crisis on government finances in the Eurozone;
- to evaluate why bailouts were provided and what consequences result from their terms;
- to identify the changes in EMU wrought by the Fiscal Compact and banking union;
- to evaluate why the democratic basis of the EU response to the sovereign debt crisis is contested;
- to identify alternative policy responses and analyse why these have not been pursued;
- to evaluate the significance of the debate over where responsibility for the sovereign debt crisis ultimately lies.

The Politics of European Integration: Political Union or a House Divided? First Edition. Andrew Glencross. © 2014 Andrew Glencross. Published 2014 by Blackwell Publishing Ltd.

Timeline of Key Events 12.1: The Eurozone Crisis (2008-2013)

September 2008	US Investment bank Lehman Brothers files for bankruptcy, triggering global credit crunch
Late 2008	Massive intervention from US Federal Reserve and European Central Bank to provide liquidity for banking system
October 2009	New Greek government dramatically revalues size of budget deficit
May 2010	Greece shut out of international bond market, followed by EU-IMF bailout package (€11O billion)
May 2010	European Central Bank begins bond-buying program to bring down interest on debt in Italy and Spain
November 2010	Ireland shut out of international bond market, followed by EU-IMF bailout package (€85 billion)
April/May 2011	Portugal shut out of international bond market, followed by EU-IMF bailout package (€78 billion)
November 2011	Greek prime minister proposes referendum on bailout terms but is forced to withdraw idea under pressure from France and Germany
February 2012	Treaty establishing the European Stability Mechanism signed, creating a €500 billion permanent bailout fund
February/March 2012	Greek creditors forced to take €100 billion 'haircut' (i.e. loss) on their debt

	holdings
March 2012	EU countries (except United Kingdom and Czech Republic) sign Treaty on Stability, Coordination and Governance in the Economic and Monetary Union
May 2012	Ireland holds referendum successfully ratifying new EU treaty
June 2012	Spanish government declares intention to seek EU financing to help its banking sector Government of Cyprus requests emergency EU funding
September 2012	German Constitutional Court rejects legal challenge to European Stability Mechanism
September 2012	European Central Bank unveils new program of bond purchases for Eurozone sovereign debt
January 2013	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union enters into force
March 2013	Cyprus negotiates an EU-IMF bailout on condition of a special levy on savers' deposits

12.0 Introduction: The Eurozone Crisis as a Challenge to Democracy and Integration

The Eurozone crisis, which occurred after the 2008 financial crisis, is a multifaceted policy problem. It relates primarily to the stability of economic and monetary integration - in other words to the survival of the euro - but also has wide-ranging economic and political consequences. The collapse of financial institutions in the US in 2008 and a wave of bank losses that affected European-based institutions generated a huge concern over government debt in the EU Governments had to provide emergency loans to banks or to take on their debt in order to prevent them from going bankrupt and harming the rest of the economy. In this context, there was great uncertainty over how to rescue the banking system and how to fund dramatic increases in national debt. Eurozone policy makers confronted serious dilemmas about whether to provide financial support - and, if so, how - to governments that were no longer able to fund their deficits and were facing the possibility of leaving the euro. These choices had an enormous impact on the direction that integration took, raising the vital question of how far such decisions, which affect citizens' economic well-being as much as the future of the EU, can be taken democratically.

As explained in Section 12.1, European monetary integration was pursued for both economic and political reasons. Moreover, the rules behind the single currency precluded the possibility of bailing out governments in financial difficulty. The mechanism for avoiding this situation was the Stability and Growth Pact, supposed to enforce budgetary rigor across the Eurozone. Yet the 2008 financial crisis sparked not only a banking crisis but also a sovereign debt crisis, as governments in several Eurozone countries struggled to find the funds to rescue their insolvent banks. This problem highlighted the fact that monetary union was not accompanied by a **banking union**: that is, national governments -remained responsible for regulating and rescuing banks from bad debts. The size of the latter was 80 huge that governments in Greece, Ireland, Portugal, and Cyprus could not afford to borrow such sums on the financial markets. In this context, Eurozone countries had to decide whether to find a way to give emergency funding or else let these

governments withdraw from the euro, risking unpaid debts and a new round of huge bank losses.

The decision to bail out these governments - which was accomplished by providing them with enough funding to make up for the shortfall between tax revenue and spending - was taken because this was the less costly option. Consequently, the most important aspect of the bailout concerns the terms under which funding was provided. The discussion in Section 12.2 shows how, within the Eurozone, Germany took the lead in determining the conditions under which other countries gave emergency financial assistance. To reassure the financial markets and taxpayers asked to guarantee the bailouts, German Chancellor Angela Merkel successfully pushed for new EU treaties designed to establish a permanent bailout mechanism, accompanied by measures to improve national fiscal responsibility. These innovations were further accompanied by an evolution in the operation of the European Central Bank (ECB) and by gradual progress toward an eventual EU banking union.

How the EU responded to the crisis is an ongoing source of controversy. There was, in the first place, criticism of the democratic legitimacy of designing bailouts that require public spending cuts alongside fundamental socio-economic reform. Similarly, experts and politicians called into question whether these bailouts were the right solution and argued over where blame for the crisis lies. All three controversies are treated one by one in Section 12.3 and made to reveal the complexity of the politics behind the sovereign debt crisis. In particular, the political division that became apparent in the Eurozone is one between the northern countries asked to provide bailout funds and the southern countries in need of them. Northern countries blamed their southern In the Shadow of the Eurozone Debt Crisis neighbors for not being fiscally responsible enough, while their southern neighbors complained about being locked into a currency union that made their firms uncompetitive.

Reflecting on what the sovereign debt crisis means for the future of integration, the chapter concludes by showing how both the crisis and the EU's response

illustrate fundamental characteristics of contemporary European integration. In the face of an unexpected emergency, national politicians took the lead and pressed ahead with more integration. The results depend on national acceptance not just of the bailout provisions, but also of the enforcement of debt brakes (national legal limits on budget deficits) mandated by the new EU treaty. This means that democratic politics at the national level will continue to have a fundamental influence on EU affairs. Yet the fact that arguments over how to resolve the crisis dominated national as well as EU politics clearly demonstrates the end of the separation between national and EU politics, at least for countries with the euro.

12.1 The Causes of the Eurozone Crisis

The introduction of the euro was a logistical success, as the euro smoothly replaced national currencies in physical and digital transactions and became a major world currency, second only to the US dollar. Firms from other countries doing business in the Eurozone used this currency for trade, while central banks and financial institutions sought to hold euro-denominated national debt as a safe investment. Yet, even before its launch, the euro project was called into question (Feldstein 1997). There were many doubts surrounding the economic and political benefits of economic and monetary union (EMU). Of particular concern was the design of EMU, which relied on having an independent central bank without a central government- that is, without integrated tax and spending policies - in what might not be an optimum currency area (see Section 5.2). While the crisis afflicting the Eurozone since 2009 might not be a straightforward vindication of these doubts, structural issues to do with how EMU was designed play a large role in explaining the difficulty the EU faced in responding to the crisis. This response is the subject of Section 12.2; in the present section the focus is on understanding the design of EMU and the unfolding of the Eurozone crisis in the wake of the 2008 global financial crisis.

12.1.1 Benefits and concerns surrounding the European Monetary Union (EMU)

Politically, the driving force behind EMU was the desire to cement ever closer integration after the end of the Cold War by tying a reunited Germany into unprecedented institutional cooperation in Europe (Feldstein 1997). In economic terms, the creation of the euro was sold on the basis of the benefits this would bring to trade and investment by eliminating the costs of currency exchange and by making price competition easier, which is anti-inflationary. However, EMU did not involve just making business easier for firms. Its mechanism rested on rules for fiscal stability - the Stability and Growth Pact (SGP see Box 5.1) - that would prevent governments from borrowing too much on the back of a strong currency. In order to meet these conditions, Ireland, Portugal, and Spain reorganized their public finances so as to lower the total public debt below the 60 percent of GDP allowed by the Maastricht Treaty (Lane 2012). Italy and Greece never achieved this target but were nonetheless admitted into the euro, while France and Germany broke the terms of the Stability and Growth Pact with impunity, in the mid - 2000s, by running up annual deficits above the permitted 3 percent threshold.

Nevertheless, the prelude to the introduction of the euro saw an improvement in the fiscal positions of states that traditionally struggled to rein in public debt. Italy, most notably, enjoyed a virtuous circle as the interest rates of prospective Eurozone countries converged on the lower German one - the economic core of EMU. This made it easier to balance budgets, as the cost of servicing national debt decreased substantially (Marsh 2009, 205). The period after the launch of the euro was also beneficial for states accustomed to paying a higher rate of interest on debt: Although individual governments were responsible for their own debt, financial markets were not overly worried about differences in public finances because the SGP set national limits on Eurozone debt. As a result, countries such as Greece and Italy continued to pay low interest on their debt, which investors ostensibly regarded as a safe investment, like that of Germany (Lane 2012).

However, there is a less visible feature of EMU: having a shared currency ultimately puts pressure on participating governments to adopt more liberalizing policies for improving national competitiveness (Hall 2012). A single currency does more than just complete a single market - the ‘one market, one money’ slogan the Commission advocated. In addition, monetary integration adds impetus to deregulate in areas beyond formal EU competence or where EU legislation is hard to adopt - for example taxes on labor, services, employment contracts. This pressure comes from being locked into a common currency, which makes **currency devaluation** longer an option. In this context, a government in a country whose goods or services become less competitive than those of another country - either by being more expensive or by being poorer in quality - cannot suddenly level the playing field by lowering the value of its currency. Under a shared currency, competitiveness has to come instead by changing costs - most obviously by lowering the salaries, or by improving productivity through investment and innovation (Marsh 2009, 246). This is a longer term form of adjustment to differences in productivity than devaluation, but economists consider it a better means of achieving lasting and stable growth, as recurrent devaluations scare off investment and discourage entrepreneurship. Politically, however, lowering production costs is very challenging, as it translates into breaking union power, lowering wages, and reducing employment rights. These kinds of measures are precisely what the EU has asked for in return for the loans given to countries such as Greece in order to plug gaps in their public finances, as discussed in Section 12.2. From the start, some EU member states, namely the UK, Denmark, and Sweden, refused to accept this euro bargain. Interestingly, these countries all experienced significant recessions in the early 1990s resulting in currency devaluations, and, in response, they introduced various measures designed to reduce government spending and to increase competitiveness. More importantly, governments and citizens in all three countries were reluctant to relinquish national control over interest rates and the (emergency) possibility of currency devaluation in return for gains in trade and in fighting inflation. Indeed, evidence for the euro’s success on these terms is mixed. Trade in the Eurozone increased by 10-15 percent within half a decade (Sadeh 2012), but overall economic growth was actually very similar among Eurozone and non-euro EU

countries in the decade before the financial crisis (Sadeh 2012, 229). Moreover, while the ECB managed to accomplish its statutory goal of achieving an inflation rate of 2 percent or less during this decade, non Eurozone countries such as Sweden and the United Kingdom also achieved this rate (Sadeh 2012, 237-238). Yet the problem with EMU is less that it disappointed expectations about stimulating growth than that it failed to prompt productivity gains across the Eurozone. Imbalances in competitiveness and productivity made the Eurozone weak in the face of an unexpected crisis, which came in the form of a worldwide banking crisis that began in the United States.

12.1.2 The global financial crisis' effect on the Eurozone

The collapse of several banking institutions in the US in 2008 led to a wave of private debt defaulting: individuals no longer able to repay loans and mortgages caused enormous losses for banks. The wave affected European-based financial institutions, which were also exposed to these defaults. In this economic climate, banks immediately became wary of lending to one another. Indeed the banking crisis was so severe that many important financial institutions were threatened with **insolvency** (that is, with having debts outweigh their assets). With no Eurozone-wide, mechanism for rescuing banks from insolvency, it was up to national governments to step in and lend to the banks, even if this meant additional national debt.

Banks, pension funds, and sovereign wealth funds (strategic financial reserves held notably by oil-exporting countries) lend money to governments that need to finance the shortfall between revenue and spending through borrowing. Suddenly governments were asking these institutions for enormous amounts of money - to be repaid through future taxation - in order to recapitalize the banks that had been affected by huge debt write-offs (this money was to be repaid through future taxation). Investors thus became concerned about government debt in the Eurozone. The concern reflects the sheer amount of debt taken on by governments to bail out banks otherwise threatened with bankruptcy - an amount that potentially

affected governments' future ability to reimburse national debt. Given the sums involved, this fear about national solvency was perfectly understandable. In Ireland, rescuing the banks cost 40 percent of GDP (Shambaugh 2012) - a necessary evil, as a banking collapse would be even more severe, wiping out customer savings, freezing the flow of credit in the economy, and even raising the risk of civil strife.

When countries intervened to protect their banks from insolvency, they did so in a context in which the banking sector had grown enormously since the creation of the euro. Bank lending had increased as EMU facilitated lending within the Eurozone, while lower interest rates allowed individuals to borrow more for consumption (mortgages, credit cards, and so on). These developments illustrate the risk of having a shared currency without a banking union to coordinate the regulation of banks (for instance the way they make loans) and their rescue in crisis moments (say, by guaranteeing deposits or by injecting capital to prevent insolvency). In the EU, banking regulation and recapitalizing banks are the responsibility of member states, unlike in federal systems such as the United States, where the federal government alone is responsible (Shambaugh 2012).

The consequence of investors' fears about national solvency was to freeze up the credit available to certain governments desperate to cover the difference between spending and tax revenue. Such shortfalls existed not just because of the need to cover bank losses, but also because of a dramatic slowdown in the world economy. In times of economic recession, tax revenue from companies and individuals falls, while spending on welfare (notably unemployment) increases, hurting public finances. Consequently the predicament facing Eurozone countries was either to borrow money from other Eurozone countries or else to go bust by failing to make payments on national debt or by not paying salaries, pensions, and other liabilities.

These concerns about the solvency of Eurozone countries first surfaced in Greece in late 2009. After the general election of October 2009, the new Greek government dramatically announced that its annual budget deficit would be nearly 13 percent of GDP. This represented twice the previous government's estimate and four times the amount allowed by the Stability and Growth Pact. Immediately afterwards, Greece's

total debt was re-evaluated at around 130 percent of GDP, more than twice the statutory 60 percent limit inscribed in the EU treaties. This revelation left financial markets reeling and meant that, to attract buyers for 10-year government **bonds**, Greece had to pay an interest rate 4 percent higher than the market rate for equivalent German debt. As financial institutions were faced with this shocking news, their fears about the state of government finances spread. Soon after Greece, Ireland and Portugal started having to pay a much higher rate of interest, too, when selling government bonds - that is, when taking on debt to cover shortfalls between spending and revenue. This higher interest rate represents the greater risk associated with financing Irish or Greek debt by comparison with financing German debt: the cheapest rate was available to the government most likely to repay its debt.

Greece's debt situation is by far the most catastrophic in the Eurozone (Greece has run budget deficits of around 5 percent per annum from 2001 to 2008, by comparison with an EU average of 2 percent) and is largely explicable through domestic factors (Featherstone, 2011). By contrast, Ireland before 2008 was cutting its overall public debt to GDP ratio, as was Spain. Yet these countries were badly hit by the global recession, as well as by the collapse of house prices following an unsustainable construction and financing bubble - both of which lowered tax revenue while forcing up public spending on unemployment assistance. At the same time countries across the Eurozone also had to borrow to finance the recapitalization of banks that had made bad loans. Higher interest rates on debt in 2010/11 thus came at the worst possible time for Greece, Ireland, and Portugal - countries with precarious public finances during a severe global recession. This generated a vicious circle, as higher interest rates on public debt meant higher government deficits (more money needs to be spent to service the debt), which in turn require more debt to be issued at a higher interest rate. Three Eurozone countries,

Box 12.1 Key Concept: Sovereign Default

A sovereign (that is, a sovereign state) is in default when it cannot or will not pay back its debts in full. History is littered with examples of governments that have defaulted; there have been 320 such defaults since 1800 (Reinhart and Rogoff 2009), and they bring a variety of consequences. Failure to repay debt is certainly not a cost-free option: a sovereign that defaults will face enormous problems borrowing money again, while the domestic economy will suffer, as banks write off their holdings of government debt and foreign investors withdraw. This scenario occurred in Argentina in 2002, when the country ceased making payments on its debt. Politically, however, this may be a lesser price to pay than introducing tax hikes or making huge spending cuts. The **International Monetary Fund (IMF)** acts as a lender of last resort to governments in this predicament precisely because the effects of a default are most damaging, both internally and externally, as foreign creditors (for example pension funds) lose out. IMP support comes with conditions attached, so as to ensure that the emergency funding is eventually paid back (this enables it to help other countries in the future). Yet national debt totaling more than 120 percent of GDP is considered 'unsustainable' under IMP rules. This was the situation facing Greece in 2012, which is why the IMP and the EU agreed to a partial write-off of its debt. At €100 billion (out of a total debt of approximately €350 billion), this is the largest sovereign default in history, although Greece itself is no stronger to default, having defaulted in the 1830s, in 1893, and in the 1930s (Featherstone 2011).

Greece, Ireland, and Portugal, found themselves in this position within the space of a year, risking a sovereign default (see Box 12.1) or an exit from the Eurozone if other members had not provided them with emergency loans - a process discussed below in Section 12.2.

12.2 The Travails of Formulating an EU Response

A Eurozone bailout of countries in financial difficulty was not supposed to happen. Article 125 of the Lisbon Treaty states that heavily indebted countries will not have their debts paid by others. More importantly, the SGP was designed to prevent governments from getting into this situation. However, it was in fact easier to accrue such debts, given the lower interest rates available to countries such as Greece and Italy in the first decade of the euro, although Ireland and Spain, which later on had similar debt issues, kept within the SGP rules. Politically, in the midst of a severe economic shock, it was never going to be easy to find a solution that required governments to take on huge financial commitments to keep the Eurozone intact. In particular, there was a split between governments in a healthy fiscal state (low annual debt and easily sustainable total debt) and ones worried about their own finances. This tension, coupled with the sheer size of the funding required and the speed at which market fears spread, made for a protracted response to the Eurozone sovereign debt crisis.

12.2.1 Deciding whether to provide a bailout and on what terms

As the cost of issuing new debt in Greece, Ireland, and Portugal became prohibitively expensive, or insufficient to cover their spending commitments, the policy choice was a binary one: leave the euro or negotiate a bailout. A country could in principle leave the single currency, although there is no official legal mechanism for this (Deo, Donovan, and Hatheway 2011). This would offer two potential advantages for resolving fiscal difficulties. A new national currency would be much weaker than the euro, boosting exports and hence growth. Being sovereign over one’s currency also gives governments the ability simply to create money to service debts and to pay for public spending. In this scenario a central bank issues new money to cover government spending by buying government debt directly from the government. Technically, EU law prohibits all member states from financing their deficits via

central bank credits (Article 104 of the Maastricht Treaty), but in a crisis situation a government may well consider this opinion. This explains why the ECB was designed to be completely independent and aloof from political considerations, so as to be completely focused on fighting inflation - although the Eurozone crisis has led to some changes in its monetary policy (see Box 12.2).

Creating money is an extreme measure and one traditionally believed to generate high inflation, which hurts ordinary citizens' standard of living and drives up interest rates, imperiling government finances over time. Devaluation will also have an inflationary effect in countries heavily reliant on imports, as the latter become much more expensive. Additionally, citizens will anticipate a decision to leave EMU and are likely to withdraw their euros while they still can - a situation known as a 'run on the bank' which can only undermine the domestic banking system further. Politically and economically, therefore, exiting the euro would be very costly, especially in countries like Greece, which rely on energy imports and have weak export sectors.

The costs of Greece (or any other country) leaving the euro would not be borne just by its firms and citizens. Banks across the rest of the Eurozone that lent money to Greek companies and individuals would suddenly see their loans converted into a new and weak national currency. Hence creditors would be left with repayments in a depreciating currency; as a result, banks in the EU would be exposed to a new round of bad debt. Another concern surrounding a withdrawal from the euro is the contagion effect, whereby financial markets would speculate on who might be next out of the single currency, speculation likely to trigger instability and runs on banking systems across the Eurozone. This kind of contagion already occurred over the course of 2010-2012. Investors concerned about Greek sovereign debt became wary about lending money to Ireland and Portugal, which meant that these countries had to issue debt at higher and higher rates of interest, until the rate became unaffordable. The same process forced up interest rates in Spain and Italy in 2011. Thus, even if the Greek economy is very small,

Box 12.2 Case Study: The Evolving Role of the ECB

Based in Frankfurt (Germany), the ECB has it as its principal aim (according to the EU treaties) to keep inflation at or below 2 percent a year. This objective was a key demand of the German government, which was only prepared to accept EMU on the basis of establishing an independent central bank that would be serious about preventing inflation (Marsh 2009). When the ECB was established, countries participating in the euro provided gold and foreign exchange reserves totaling €41 billion so as to be able to intervene if necessary to stabilize the currency against the dollar, yen, and so on. Although the ECB is designed to be apolitical, the Eurozone sovereign debt crisis saw EU politicians place great pressure on the ECB to do more to resolve the crisis. One measure that the ECB took was to inject money into the fragile EU banking sector by providing €500 billion in low-interest loans in December 2011. This move aimed to encourage lending to companies, stimulate consumption and get banks to buy Eurozone debt so as to drive down interest rates on repayments. Nevertheless, politicians in countries struggling to afford high interest repayment on their debt (like Italy and Spain) argued that the ECB should buy up government bonds in massive quantities, in order to drive down the interest charged. This pressure bore fruit with the launch, at the beginning of 2013, of Outright Monetary Transactions (OMT), a scheme for buying government debt from countries that agree in return to implement reforms so as to balance their books. To offset the risk of inflation - an unlimited bond-buying spree would be the equivalent of printing money - the ECB is 'sterilizing' the purchases. This involves selling off assets (for example other countries' bonds) equivalent to the sum of the bonds bought via PMT, so that no new money is created. Nevertheless, bond buying via sterilization is controversial and was rejected by the German representative on the ECB board. Should the ECB run out of assets to sell to sterilize bond buying, it will need to ask Eurozone countries for more.

representing less than 3 percent of Eurozone GDP, the financial repercussions of this country exiting the euro are estimated to give the astronomical sum of €1 trillion (Moravcsik 2012, 61). Consequently there were good reasons why Eurozone governments decided to proceed with bailout packages for countries that could no longer borrow on the international financial markets. The major problem was devising the terms for such a deal.

Determining the conditions on which to provide a bailout, first for Greece and then for Ireland and Portugal, posed a question of leadership and legitimacy. The president of the Commission as well as the new president of the European Council entered the fray at various points. However, the source of these emergency loans was the member states, complemented by monies from the IMP. Since national governments and their taxpayers would have to guarantee the funds, it was national leaders who played the decisive role in devising the terms of the bailouts. In particular, the German chancellor, Angela Merkel, played the most prominent role as leader of the Eurozone's major economic power and as the greatest financial contributor to these schemes.

Merkel's proposed solution involved giving emergency funding to countries frozen out of the financial markets in return for dramatic domestic economic and fiscal reforms. For instance, the agreement with Ireland spelled out which taxes should be raised and where public spending should be cut, notably by reducing public service employment. The objective behind the measures is to balance government spending quickly, so that within the space of a few years that government may be able to borrow again on the markets, at reasonable interest rates, and eventually accrue a surplus to reduce overall debt. Bailout funds are provided in tranches, as a team of EU and IMP economists monitored public finances in order to check whether governments stick to the terms of the deal. Attaching these kinds of conditions is in fact standard practice for IMP emergency loans to countries in currency and financial crises, although critics argue about the utility, and legitimacy of these agreements (Collier and Gunning 1999). Indeed Eurozone countries requiring emergency funding experienced waves of protests at having government spending and taxation decisions imposed from outside, as will be discussed in Section 12.3. For European

integration, this form of top-down economic management constitutes an historic turning point: never before has the EU been so implicated in deciding on national tax and spending policies.

The IMP provided some of the funds for Greece, Ireland (here Denmark, the United Kingdom, and Sweden provided extra bilateral funding), and Portugal; but its resources were insufficient for those governments' needs. This is why the EU needed to create from scratch a temporary funding mechanism to cover €80 billion for Greece (accompanied by a further €100 billion in February 2012), €67.5 billion for Ireland, and €52 billion for Portugal. This gave rise to thorny legal questions, since the EU treaties did not specify any mechanism for bailing out a Eurozone country and this meant that any funding arrangement would have to be temporary, unless the treaties were formally changed.

Given the risk that uncertainty over public finances would spread to countries such as Italy and Spain (as in fact happened by late 2011), Merkel pressed for the creation of a permanent bailout fund. The plan was to reassure markets about the long-term commitment to the single currency by creating a €500 billion fund called the **European Stability Mechanism (ESM)** and designed to provide loans to governments experiencing financial trouble. Establishing the ESM required a new treaty, which was signed at a European Council summit in February 2012; but Eurozone creditors, led by Germany, demanded a counterpart. This came in the form of a Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (also known as the Fiscal Compact), designed to create more robust rules for ensuring national fiscal discipline.

12.2.2 The Fiscal Compact and moves toward a banking union

Negotiations over the Fiscal Compact were swift but not without complications, the impetus being again provided by German Chancellor Angela Merkel. Her overriding concern was that a new treaty would reassure German public opinion that the EU bailout mechanism was being accompanied by serious measures to prevent future

crises requiring contributions from German taxpayers. Indeed the most important of these measures was inspired by recent German legislation designed to make it constitutionally impossible to run up government debt in the long term.

At the heart of the 'Fiscal Compact' - so called because it specifies new rules on how governments should manage their finances - is the creation of binding national commitments to run balanced budgets. These rules for balanced budgets are modeled on the Schuldenbremse ('debt brake') that Germany introduced in 2009, intending it to produce a balanced budget by 2020 (Switzerland has had one since 2001). The Fiscal Compact compels its signatories to pass national laws limiting budget deficits to 0.5 percent of GDP (the United Kingdom and the Czech Republic have not signed it). This figure is calculated in terms of the business cycle, permitting temporary spending rises during recessions. All the countries using the euro had to ratify the treaty, which entered into force on January 1, 2013. Eurozone countries had a major incentive to introduce a national debt break immediately into law: from March 2013 loans made by the ESM are conditional on a member state adopting the national debt brakes mandated by the Fiscal Compact.

Although this treaty does not give the EU competence to control how countries actually enforce their national debt brakes, the Court of Justice is empowered to verify whether member states actually pass this legislation within the specified one-year time- frame. Financial penalties of up to 0.1 percent of GDP can be imposed on governments that fail to adopt this legislation. An additional constraint imposed on signatories is the obligation, for countries with a total debt of more than 60 percent of GDP, to reduce this debt by one twentieth per year until they reach a position below the 60 percent threshold. This commitment only becomes binding 3 years after an annual budget deficit has returned to below 3 percent of GDP. Taken together, these commitments are supposed to remove the likelihood of governments running up new debts and to reassure financial markets, eventually lowering interest rates on debt.

However, the new treaty does not significantly enhance the EU's ability to control national governments' fiscal decisions. The Fiscal Compact relies instead on getting

member states to make the provisions of the SGP binding under national law. There was a suggestion of empowering the European Commission's monitoring ability by giving the Commission the right to veto national budgets that do not conform to EU debt rules. Again, this was an idea originating in Germany and supported by countries such as Finland and Austria, which managed to keep control of government finances even amid global recession. A majority of other member states successfully opposed this move toward enhanced supranational budgetary control - an unsurprising opposition, given the number actually in breach of the rules at the time (see Figure 5.1). Consequently there are fears that the supranational mechanism for enforcing fiscal rigor will again be too weak, meaning that the system will be reliant on national enforcement via debt brake legislation. In any case, the operation of debt brakes will take time, as member states are expected to use transitional arrangements to bring deficits down gently while the commitment to pay back 1/20 of total debt over 60 percent of GDP can only be enforced after a 3-year period - that is, not before 2016 (Dullien 2012).

Since the Fiscal Compact is only a long-term measure for fixing debt, EU leaders also took gradual steps toward creating a banking union. These moves were designed to make it possible to deal with more immediate matters and to resolve problems that were the primary cause of many Eurozone countries' bad debts. Starting in 2009, the European Commission proceeded to 'stress tests' on EU banks, in order to check whether the latter have sufficient assets to cope with bad debts. Since 2010, this is now the responsibility of the European Banking Authority. This independent agency increased the capital requirements for banks in 2011, obliging banks to hold more safe assets as a percentage of their loans. The purpose of this measure was to restore confidence in inter-bank lending by preventing rogue banks from making risky loans. In addition, in December 2012 the EU agreed to give the ECB the power to supervise the EU's banks from 2014 on, so as to prevent risky lending practices or unsustainable business models. This is a major step in the direction of breaking the link between bank losses and sovereign **liquidity** problems of the kind that necessitated bailouts in Ireland and Portugal.

Indeed the link between bank bailouts and sovereign debt was further illustrated by the case of Spain. In total public debt was low - it was below the 60 percent threshold prior to the 2008 financial crisis - but Spanish banks were badly affected by a housing boom and bust that resulted in unpaid loans to the estimated value of €60 billion. As a result, in June 2012 the Spanish government officially declared that it needed EU help to support its banking system, something the country could no longer afford to do. This meant that Spain became the fourth country to receive emergency EU funding, although in this instance the funding was specifically earmarked to rescue the banking sector. In the same month the government of Cyprus also requested emergency EU funding and began negotiations for the fifth EU - IMP bailout to help with the cost of a bank bailout. Between 2008 and 2012 the Cypriot public debt rose from 50 percent to 85 percent, while the banking sector swelled to a figure eight times larger than GDP; hence the country could not afford to re-capitalize its banks. Cyprus' bailout was particularly controversial, as the EU and the IMP made it conditional on raising funds via a special levy on savers' deposits.

In November 2012 the European Commission approved a €37 billion euro package for four heavily indebted Spanish banks, in return for major restructuring that involved significant branch closures and job losses. This was another milestone, as it moved the Eurozone closer to a system of mutual bank support, although other aspects of a banking union - such as a commonly funded bank deposit guarantee - remain under discussion to date. Ultimately the intention is to counteract the fact that, as one economist put it, EU 'banks are international in life, but national in their death' (Goodhart 2009, 16). However, this move involves mutualizing financial risks across member states, which is highly controversial - as indeed are many aspects of the EU response to the Eurozone crisis.

12.3 Criticism and Controversies Surrounding the EU Response

Responding to the Eurozone crisis was a politically fraught affair. This was bound to be the case, given the need for large financial guarantees to bail out governments unable to borrow on the markets. Yet the controversy and criticism surrounding how the EU dealt with the aftermath of the financial crisis involves more than just wrangling over money. Three separate concerns are central to the politics of the Eurozone sovereign debt crisis: the issue of how democratic the decision-making process was; that of whether the measures taken were the right ones; and the question where the blame should lie for the origins of the crisis. This section explores all three concerns one by one.

12.3.1 Democratic decision-making?

Decision-making in a crisis is a test for any political system. When the repercussions of the 2008 financial crisis struck the Eurozone, the problem was not just the EU's ability to take decisions but also its ability to elicit democratic approval for tough choices. Of course, the quality of democracy in the EU has increasingly been open to question (see Chapter 10). Yet the sovereign debt crisis posed this question in much starker terms than ever before. This was because the governments of some countries had to commit public funds in order to make up for shortfalls in the budgets of other countries, in return for major socio-economic reforms that went beyond anything conducted under the Ordinary Legislative Procedure. Both moves met with deep domestic opposition: citizens from the creditor countries were skeptical about the wisdom of providing bailouts, and there were mass protests against socio-economic reforms being imposed in recipient countries such as Greece and Spain.

In this context the interplay of national and EU politics was crucial, as politicians had to satisfy domestic public opinion while also making decisions for the broader European interest. The case of Germany illustrates well the dilemma: Chancellor

Angela Merkel knew that her citizens were very wary about providing emergency loans to Greece - a skepticism that fits exactly with the notion of a ‘constraining dissensus’ discussed in Section 11.1. German public opinion blamed government economic mismanagement for Greece’s debt problems - mismanagement exemplified by the fact that full pension rights were based on 35 years’ contributions, 10 less than in Germany. Merkel thus wanted to design a bailout deal that would convince her national voters that the EU was serious about reforming how countries run their economies. In addition, she was concerned that the German Constitutional Court would rule that financial support for Greece and others was illegal unless a new treaty overturned the Lisbon Treaty’s ‘no bailout’ clause (Paterson 2011).

Consequently, German domestic preferences were central to how Merkel approached solving the sovereign debt crisis. The insistence on getting a deal that satisfied these preferences engendered some hostility from other EU member states, concerned as they were that their voices were not being heard. Hence this attitude on the part of the German leader raised the specter of a German-run Europe. At the popular level, anxiety about German dominance had the effect that street protests in Greece or Portugal against reforms introduced to satisfy EU creditors were invariably accompanied by anti-Merkel slogans and allusions to Nazi-era Germany. These demonstrations were also a manifestation of domestic opposition to EU-imposed socio-economic reforms, notably tax increases, reduced pension or unemployment benefits, and public sector layoffs. Such measures, an essential part of the terms of the Eurozone bailouts, were portrayed as an imposition of austerity coming from external creditors without the approval of national voters. When, in November 2011, the Greek prime minister proposed a national referendum on the terms of the EU bailout, European leaders successfully applied diplomatic pressure for him to abandon this plan, which led to his eventual resignation. EU leaders were afraid that voters would reject the deal, thereby unraveling their attempts to solve the crisis.

Another indication of the external constraints facing member states’ ability to decide their own affairs came from Italy. Having a very large public debt - namely

one of over €2 trillion - Italy has long been preoccupied with interest rates, since small variations have large effects on the cost of servicing its outstanding debt. In late 2011 financial markets rapidly lost confidence in the Italian government's ability to reform its public finances. This was not just the result of contagion, as fears about government finances spread from Greece to other countries, but also a damning verdict on the inability of Prime Minister Silvio Berlusconi to carry out the numerous pledges to reform the Italian state (Jones 2012). As pressure to improve Italian public finances was also coming from European leaders, namely Angela Merkel and Nicolas Sarkozy, as well as from the ECB, Berlusconi lost his parliamentary majority and resigned. In his place came, without a new election, a non - partisan government led by former EU Commissioner Mario Monti. The aim of this move was to allow experts - a so-called technocratic government above partisan politics (see Chapter 9, Glossary) - to stabilize the country's finances and to reassure financial markets until the elections of 2013. External actors such as markets and powerful EU member states thus seriously constrain the policy choices available to voters in weaker EU countries.

The Italian example is also emblematic of government instability across the EU since 2008. That is, governing parties have found it extremely difficult to win in re-election campaigns, as shown by the electoral defeat of ruling parties in France, Finland, Greece, Ireland, Portugal, Slovakia, and Spain. In many of these cases electoral unpopularity was directly linked to a government's implementation of socio-economic reforms and moves toward fiscal rigor. Moreover, in the Netherlands, the government of Mark Rutte fell in April2012 when his coalition failed to get parliamentary support for budget cuts aimed at conforming with the Stability and Growth Pact. Yet a change in government does not affect a member state's legal obligations: ruling parties and coalitions still have to meet EU budget rules or, in the case of recipients of bailouts, meet the terms of these agreements. Consequently popular resentment against austerity has not led to a change in policy direction; this reveals just how constrained economic sovereignty has become. Nevertheless, there was a heated debate over whether public belt-tightening was the most appropriate solution to the crisis.

12.3.2 The right response?

Opinions among experts and politicians differed considerably over the best way to resolve the sovereign debt crisis. As an alternative to the existing bailout mechanism, radical proposals involving changing the nature of debt and of the ECB have been floated. Here the central concern is that the emphasis on fiscal responsibility, often

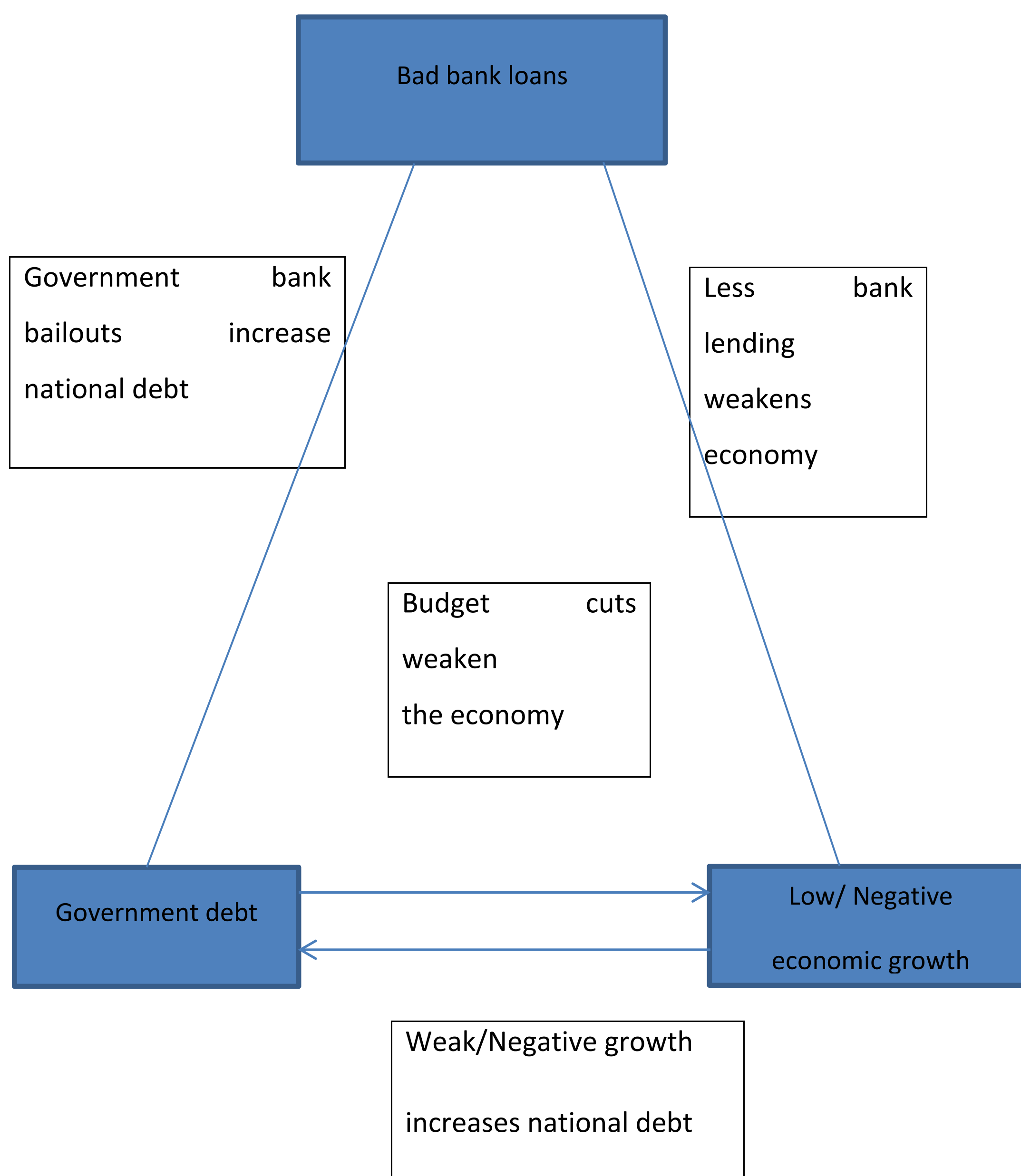

Figure 12.1 The vicious cycle of government debt and weak growth in the Eurozone

pejoratively labeled ‘austerity’, is counterproductive. This is because the sudden implementation of tax raises and spending cuts forces an economy to contract. The kinds of cuts that are being asked of Eurozone countries are indeed drastic: a reduction of the budget deficit by 11 percent of GDP in Greece within 3 years, a 9 percent cut in Ireland over 5 years, or six percentage points in Portugal in 3 years (Hall 2012). For countries facing liquidity and even solvency problems, a recession - in other words a fall in overall GDP - exacerbates these woes, creating a vicious cycle (Shambaugh 2012). A shrinking economy means lower tax receipts and hence a bigger budget deficit, while at the same time increasing the debt to GDP ratio, as illustrated in Figure 12.1.

According to some experts, one way to break this cycle would be for the ECB to act as a lender of last resort in the bond markets. This move targets the high interest rate on national debt, which has caused such budgetary problems for certain countries in the Eurozone. High interest rates on debt, which indicate low market confidence in a country’s economy and fiscal position, leave governments facing even greater budget shortfalls on top of those caused by recession. This situation contrasts with the virtuous circle prior to the creation of the euro, when diminishing interest rates on debt - a sign of the various markets’ confidence that monetary integration would improve fiscal responsibility - helped cut deficits. The argument here is that, if the ECB promised financial markets unlimited funds to buy national debt within the Eurozone, then interest rates on debt would stabilize at an affordable level (De Grauwe 2011).

The ECB already functions as the lender of last resort to the Eurozone’s banks: it provided huge sums when these banks suddenly began to stop lending to one another and to businesses (see Box 12.2). Acting as a financial backstop for Eurozone public debt would reassure creditors holding government bonds (banks, pension funds, and the like) that they would always find a buyer - the ECB - for their holding of Greek or Italian debt. In this way the risk involved in lending money to these governments would be much lower, allowing financial markets to provide credit at an affordable rate. This move could thus break the contagion effect, in which worries about one country’s debt spread to others. With lower interest rates on debt, the

shortfall public finances in countries such as Greece, Ireland, or Spain would also be lower, and this would bring less severe spending cuts of the kind that lower overall growth (Hall 2012).

Currently, direct purchases of government debt by the ECB are not permissible under the EU treaties. Direct central bank purchases of government debt are considered highly inflationary, and the mandate of the ECB, in line with the preferences of the German government when it agreed to abandon its own currency, is to fight inflation. Yet critics of this orthodoxy suggest that purchasing government debt already held by private creditors does not have the inflationary consequences of financing deficits through the method of printing money (De Grauwe 2011). The former does not involve allowing governments to spend above their tax revenues - a policy that diminishes the real value of money, thereby creating inflation - but rather provides reassurance for bondholders, encouraging them to lend.

Interestingly, both the US Federal Reserve and the Bank of England responded to the 2008 financial crisis by pursuing this policy of buying vast quantities of their own government's debt back from creditors. The risk in the Eurozone is that massive bond buying would saddle the ECB with debts, creating huge liabilities for taxpayers should a country default, just as holders of Greek debt lost €100 billion in 2010. Starting in 2013, the ECB was permitted to buy huge quantities of government debt from private bondholders; this shows an evolution in the orthodoxy of Eurozone central banking (see Box 12.2). The message was underscored by Mario Draghi, the president of the ECB, who in 2012 declared that 'the ECB is ready to do whatever it takes to preserve the euro'.

A second, growth-focused alternative to the bailout system involves changing the way governments issue debt in the Eurozone. The euro was originally designed as one currency with seventeen national debts. Given the liquidity problems facing countries within the Eurozone - that is, their ability to borrow in order to finance deficits during a global slump - the suggestion is to move toward a single Eurozone debt. This is a very radical proposal in that mutualizing debt means that taxpayers

from countries with sound finances become responsible for paying debts accrued by those of others. In other words, this kind of arrangement, dubbed '**fiscal union**', involves real financial solidarity across member states. The Eurozone bailouts do involve some such solidarity, but one resting on 'guarantees for borrowing rather than direct transfers of funds' (Hall 2012, 364). By contrast, a single Eurozone debt entails that all taxpayers share the responsibility for servicing and, eventually, repaying the debts accrued by other national governments.

This kind of solidarity is not a very attractive proposition for taxpayers from countries such as Germany, Finland, Austria, or the Netherlands, which are already net contributors to the EU budget. However, from the perspective of countries struggling with large debts, such as Greece and Italy, a fiscal union would be a huge advantage, as it would remove obstacles to borrowing cheaply. For this very reason policy-makers fear that mutualizing debt would remove the incentives for these governments to reform their public finances. Consequently a full fiscal union is not an immediately realizable goal. Rather, an idea often floated during the Eurozone crisis was to create a new kind of debt: Eurobonds. These would be an important stepping stone toward full fiscal union and could be used during the crisis to reduce borrowing costs or to finance growth-inducing public spending. To avoid the problem that cheap borrowing will hinder fiscal reform in certain countries, one Eurobond scheme involves issuing a Blue Bond covering national debt up to 60 percent of GDP, while a separate Red Bond would be issued by national governments for borrowing above that rate (Delpla and Weizsacker 2010). Blue Bonds, being more secure, would be much cheaper to finance than Red Bonds, providing a strong incentive for governments to balance their books. The heated debate that ensued from proposals to change government borrowing in the Eurozone pitted southern Eurozone countries against northern ones (see Box 12.3), thereby highlighting a further dividing line in the politics of the sovereign debt crisis: who exactly is to blame?

12.3.3 Who is to blame?

Divisions in the Eurozone over how to respond to the sovereign debt crisis reveal the socio-economic as much as political differences between member states. The core areas of prosperity, centered around Germany and its immediate neighbors, are characterized by intensive capital investment, highly skilled labor, and export-led growth. This contrasts with the southern periphery, typified by Greece and Portugal but also by southern Italy, which is reliant on low-cost labor and dependent on demand-led growth (Hall 2012). Joined together under a common currency, the less competitive countries of the Eurozone lost the ability to devalue their currency. This allowed firms from more competitive countries to gain market share, to invest more and then to adapt better to changes in the global economy. Moreover, German firms benefited from lower unit labor costs (the ratio of pay to productivity) relative to the Eurozone because of high capital investment as well as weak domestic demand, more flexible working practices, and low government spending (Moravcsik 2012,59). The result was that companies in Germany became up to 25 percent more competitive than their counterparts in Italy, Spain, Greece, and Portugal (Moravcsik 2012,59). As a result, the design of the single currency itself is often identified as the ultimate cause of the fiscal problems besetting weaker Eurozone countries. However, finding a single culprit for the sovereign debt crisis risks overlooking a complex set of political and economic causes.

Given that the sovereign debt crisis relates to governments within the Eurozone having to borrow large sums and to accumulate high debts, it is necessary to examine the role played by national governments. One common accusation here is that the countries requiring bailouts have been profligate or at best careless about their finances. Infact governments' fiscal performance in the Eurozone is very mixed. Ireland and Spain abided by the terms of the Stability and Growth Pact up until the 2008 financial crisis, which is more than can be said for France and Germany (Lane 2012). Yet both

Box 12.3 Key Debate: The Eurozone Split over Eurobonds

The core idea behind reforming the existing Eurozone debt system by issuing Eurobonds is to have all countries using the euro guarantee repayment of euro-denominated debt. Each government would contribute proportionally to servicing and paying off the Eurobonds issued; this would imply fiscal union, which is actually the same principle involved in the Eurozone's European Stability Mechanism - a €500 billion permanent bailout fund established in September 2012. Yet there is great reluctance to issue Eurobonds in many northern European countries. Governments there would be expected not only to guarantee the debt of other countries, but also to pay a higher interest rate on borrowing, as the risk associated with Eurobonds would be greater than, say, for individual German or Finnish debt. This is a very hard deal to sell to taxpayers, as politicians in northern Europe worry about voters punishing them at the ballot box to support such schemes. Governments that have implemented tough measures to become fiscally responsible also expect member states in southern Europe to tighten their belts before benefiting from Eurobonds. This is illustrated by German Chancellor Angela Merkel's comment in 2011 that 'member states face many years of work to atone for past sins' (quoted in Hall 2012, 368). Moreover, populist parties such as the True Finns in Finland have garnered support by opposing Eurozone bailouts as propping up failing economies; a policy that goes against national interest. Such rhetoric thus exemplifies the 'no demos' quandary underlying the Eurobonds split (see Box 10.2). Fiscal union amounts to financial solidarity, which is a core component of being a single political community. Yet voters and politicians in many member states currently oppose this development. Consequently the Eurobonds debate is part of a wider debate over how much European integration citizens want and whether solidarity across member states can trump national interests.

Ireland and Spain experienced huge housing booms facilitated by the cosy links between developers and politicians responsible for urban planning, and these booms

generated massive bank losses as house prices collapsed during the post-2008 recession. This suggests that more could have been done at the national level to dampen such speculative construction and selling. Admittedly, these governments lacked a major policy tool for deflating the property bubble because the interest rate is set by the independent ECB. Ireland and Spain thus could not raise interest rates to discourage credit-based construction. Moreover, the credit that financed this housing boom often came from banks in northern Europe - banks in Germany and the Netherlands that would also be facing huge losses without government bailouts to those supposedly profligate countries (Moravcsik 2012, 59).

The major outlier on the Eurozone, though, is Greece. Despite the Eurozone rules, Greece's fiscal performance was very poor even before the financial crisis. The evidence points to Greece's exceptional place among pre-2004 accession countries: it ranks lowest in terms of competitiveness and has the worst rate of corruption (Featherstone 2011). Greek governance is sorely hampered by massive tax evasion and an inability to identify the total number of civil servants, whose ranks are swollen through endemic political patronage. The net result is an inability to balance spending and taxation, which explains why, when public borrowing was cheap (as during the first decade of the euro), governments resorted to accumulating debt. Of course, this response is not in itself a Greek peculiarity; Italy's debt tops €2 trillion, while France last ran a balanced budget in 1974.

Greece is thus an extreme example of the difficulty that a number of member states experience in trying to control their budgets. In the first decade of the euro, a global credit boom fuelled domestic consumption, helping growth, which in turn helped public finances (more tax receipts) - which also benefited from cheaper borrowing costs. Consequently governments faced few pressures to reform their public finances, especially as the SGP was laxly enforced. Nevertheless, some countries have been able to implement sweeping fiscal reforms of their own accord, without supranational pressure. This was the case of Sweden in the 1990s: owing to public sector layoffs and a significant reduction in welfare provision, the budget deficit went from 10 percent of GDP in 1993 to less than 2 percent in 1997

(Anderson 2001). Similarly, throughout the 2000s Germany pursued major welfare reforms and introduced a debt brake to control federal as well as regional spending.

However, the institutional capacity and the political will to implement such costly reforms varies across the EU. This can be seen from the political debates across member states on how to resolve the sovereign debt crisis. The 2012 French presidential election, for instance, was won by a center-left politician with an anti - austerity platform. Greek politics also saw a fierce battle over whether to go along with the terms of the bailouts. The socialist party Syriza, which became the second biggest parliamentary party after the 2012 election, strongly opposed EU-imposed cuts in public spending, although ultimately a coalition of parties supporting the bailout was able to form a government.

Despite these national divergences in coming to terms with fiscal problems, responsibility for the sovereign debt crisis is a shared affair. AII Eurozone countries are tied together in a closely knit political and economic sphere, which means that actions and inaction in one country have significant repercussions elsewhere. The willingness and ability to implement a series of bailouts alongside a permanent bailout fund suggest that, at the policy level, mutual responsibility eventually triumphed over the tendency to attribute blame. Yet the terms of these bailouts clearly indicate that wealthier northern European countries expect their southern neighbors to become more like them. This is by no means impossible. Ireland's ability to start borrowing on the financial markets already in July 2012 indicates that rapid fiscal improvement is possible - and Ireland was followed by Portugal in early 2013. However, the longer the sovereign debt crisis hovers over the EU, the more difficult it will be to overcome divisions and recrimination.

12.4 Conclusion: What the Crisis Means for the Future of Integration

Instead of providing a concluding summary, this chapter ends by reflecting on what the sovereign debt crisis means for the future of integration. First, though, it is important to note how both the crisis and the EU's response to it illustrate

fundamental characteristics of contemporary European integration. Never before have complicated EU policy debates played such a central role in national politics, as is shown by government instability in the face of meeting EU budget rules. This tendency is compelling evidence of the Europeanization of national politics - for better or for worse (see Chapter 7, Glossary). Equally, the response to the crisis, notably the evolution of the ECB's role and the scrapping of the 'no bailout' policy, shows the EU's capacity for flexibility (Moravcsik 2012). As is the historical trend, an unexpected situation revealed incompleteness in the stage of integration reached - the construction of monetary union without a banking union - and forced policy-makers to respond. At the time of writing, however, there is no full banking union, which means that the Eurozone remains vulnerable to the problem of bad bank debt leading to sovereign debt crises.

National leaders were at the forefront of deciding the EU response to the sovereign debt crisis, relegating the Commission and the Parliament - but not the ECB - to secondary roles. This largely intergovernmental approach is understandable because it is national governments that have to secure parliamentary and constitutional approval for bailouts and for austerity measures. Nevertheless, in a new departure for integration, it was one country in particular that set the agenda. Germany, the economic powerhouse of the Eurozone and the biggest contributor to bailout packages, played a central role in determining that indebted countries would need to implement austerity. Many governments saw their macro-economic policy options greatly constrained in order for them to meet the conditions for reforming the Eurozone instituted by German Chancellor Angela Merkel.

Citizens and politicians confronted with the *fait accompli* of the Fiscal Compact and of the ESM thus complained about the lack of democratic inputs into the EU response to the debt crisis. Only Irish voters got to vote on the new Fiscal Compact, in a referendum that passed in May 2012. Indeed, EU leaders even put pressure on the Greek government not to hold a referendum on the bailout provision. Equally, national electorates have discovered how much economic sovereignty is a cooperative affair, limiting the autonomy of national governments, notably the ability to accommodate their citizens' tax and spending preferences. In Italy a

temporary technocratic government had to be formed to reassure financial markets by reducing public spending. Moreover, governments implementing fiscal reforms have been voted out of office across the EU, even though their successors have to meet the same terms, whether in the form of the SGP or in separate bailout agreements.

Given that the debt brakes introduced via the Fiscal Compact rely on national legal implementation, successfully solving the sovereign debt crisis is crucially dependent on national acceptance of fiscal reform. National acquiescence cannot be taken for granted, as demonstrated by trends both within the countries providing bailouts and in those receiving them. In the former there is skepticism about financial solidarity, while in the latter there is popular resistance to this form of supranational economic intervention. In this context, divisions within the EU, namely the north/south split, have become apparent - and so have splits its national politics, as voters in Spain and Greece debate whether to accept the terms of the bailouts. These trends point both to the continued evolution of euroskepticism and to its growing importance within national political spheres more and more preoccupied with integration issues.

The sovereign debt crisis thus highlights the problem of economic and political solidarity across the EU. Mutual financial guarantees were necessary to preserve the single currency, but national electorates in creditor countries did not welcome this move – a clear indicator of the domestic political obstacles to creating a fiscal union. Moreover, many citizens in countries that require a bailout have objected to having to meet conditions imposed at the demand of other EU member states. The crisis also raised another issue of solidarity and unity across the EU by reinforcing the distinction between those outside of the single currency and those using the euro. The Eurozone area has strengthened its informal system of cooperation, the **Eurogroup** (euro-area finance ministers), which appoints a president and meets before the Council's ECOFIN meetings to present a united Eurozone front on economic and finance policy. However, the luster of the euro has dimmed, dampening the enthusiasm for adopting the single currency among certain post-2004 accession countries. These countries are legally obliged to join eventually.

Estonia did so in 2011, yet Bulgaria postponed its timetable for euro membership several times, even though it meets the criteria.

Equally importantly, moves toward a banking union and more economic coordination for the EU triggered added wariness toward integration among British euroskeptical parties. It was to appease euroskeptical elements in his Conservative Party that British Prime Minister David Cameron refused to sign the Fiscal Compact in 2011. This opposition left the United Kingdom very isolated, as did its reluctance to establish greater supranational banking regulation for fear of hurting the financial interests of the City of London. Indeed in 2013 Prime Minister Cameron announced his intention, if re-elected in 2015, of renegotiating the UKs relationship with the EU and then subjecting this deal to an 'in or out' referendum on staying in the EU. Around this time opinion polls suggested that 70 percent of Britons were 'not very' or 'not at all' attached to the EU. Whether this trend of seeking alternative arrangements spreads - Sweden and the Czech Republic also objected to joining the new banking union - will determine whether the EU will experience enhanced differentiated integration (see Section 9.4).

Overall, the sovereign debt crisis is perhaps the toughest challenge the EU has faced. In light of this, the choice to move toward a banking union is a clear signal that European political elites still supported more integration to resolve the vulnerability of the single currency. How much longer this tendency to resolve internal crises through greater integration will continue depends not just on what financial burden voters in creditor states will accept in exchange for keeping the euro intact. The commitment to greater integration is also conditional on the acquiescence of voters in the countries that have been bailed out, as well as in those where fundamental socio-economic reform is necessary to balance the budget. With the demise of the permissive consensus era, these voters' enthusiasm for the euro cannot be taken for granted; hence neither can national politicians' ability to persuade citizens to choose more integration. Thus accomplishing a banking union - let alone moving toward fiscal union - to strengthen monetary integration cannot be taken for granted and may be accompanied by further internal differentiation. In this context, the politics

of European integration should prove a continuing source of contestation, frustration, but also inspiration.

Guide to Further Reading

- Hall, P. 2012. The Economics and Politics of the Euro Crisis. German Politics, 21: 355-371. DOI: 10.1080109644008.2012.739614

A study from a political economy perspective showing the fundamental institutional and policy problems that resulted from joining together different kinds of economies under a single currency.

- Lane, P. R. 2012. The European Sovereign Debt Crisis. The Journal of Economic Perspectives, 26: 49-67. DOI: http://dx.doi.org/1O.1257 /jep.26.3.49

A clearly written overview of the fundamental economic processes behind the sovereign debt crisis.

- Sadeh, T. 2012. The End of the Euro Mark 1: A Sceptical View of European Monetary Union. In Hubert Zimmerman and Andreas Dur, eds., Key Controversies in European Integration, 121-129. Basingstoke: Palgrave.

A provocative take on the economic incompatibilities undermining the Eurozone, resulting in the prediction that weaker economies will leave the euro.

Discussion Questions

1. How was the design of EMU intended to prevent the need for bailouts and how well did this mechanism function?
2. Why did bad bank loans trigger a crisis of confidence in government debt among several Eurozone countries and why were particular countries affected?
3. What does the Fiscal Compact seek to achieve and how far does it change national fiscal autonomy?

4. How democratically legitimate has the EU response to the Eurozone crisis been and what political debates did it trigger in both creditor countries and bailout recipients?
5. Why is responsibility for the sovereign debt crisis in dispute? Does attributing blame matter for how to pursue institutional reform?

Web Resources

This book is supported by a companion website, which can be found at www.wiley.com/go/glencross. There you will find a list of the web links referred to in this chapter wherever you see a 'Web' icon in the page margins. In addition, you will find a list of further relevant online resources such as websites for EU institutions, political groups, archives, and think tanks, information on studying abroad, and biographies of key figures. You will also find self-assessment tools in the form of flashcards and independent study questions developed specifically for this chapter.

Glossary

Austerity

Normally a term of criticism, used to denounce spending cuts and tax rises intended to compensate for government deficits. Critics of austerity measures claim that the latter depress growth, thereby making budget crises worse.

Banking union

A system in which banks operating across different jurisdictions are nonetheless subject to common regulatory rules and are protected by a common scheme to prevent insolvency. This implies financial solidarity across borders, because banks are tied together, especially in a currency union like the Eurozone. The system also implies centrally organized powers designed to monitor whether banks play by the rules.

Bonds

A bond is a debt instrument; it pays interest and is sold by companies and governments to finance their spending. Although government bonds are normally considered safe investments, interest rates on them differ according to how good a country's finances are judged to be by investors. Small changes in interest on bonds have large repercussions on public finances in countries with very large debts (like Italy).

Currency devaluation

Devaluation occurs when a government withdraws from a currency union (or a fixed exchange rate system), causing a significant fall in the value of the national currency on global markets. This makes exports cheap and hence more competitive, but devaluation comes at a price: it makes imports more expensive and reduces domestic demand.

Eurogroup

Informal meeting of finance ministers from member states using the euro. The group meets prior to the Council's ECOFIN configuration meetings in order to devise a common approach of Eurozone countries to economic and financial policy.

European Stability Mechanism (ESM)

A permanent bailout fund endowed with €500 billion, established in 2012, with capital provided by member states. It issues emergency loans to EU countries on condition that they have ratified the 2012 Treaty on Stability, Coordination, and Governance (also known as the Fiscal Compact).

Fiscal Union

The principle that financial responsibility (e.g. for bank bailouts and debt) is shared between a group of countries. Fiscal union thus works on the basis of pooling fiscal powers so that tax and spend decisions are taken collectively, which is a major step in closer integration.

Insolvency

The inability to pay back, in full, one's debt as well as the interest upon it; this can happen to governments as well as to private firms such as banks. When a government is insolvent, investors will no longer lend it money; they will often lose money as debt goes unpaid.

International Monetary Fund (IMF)

International organization established in 1945 for the purpose of overseeing global financial stability. It performs an essential stabilizing role by providing emergency loans to countries that are suddenly unable to borrow on financial markets. It funds come from member states, and loans are conditional upon governments implementing major socio-economic reforms.

Liquidity

The ability to pay back short-term debt on time, as originally agreed. Banks and governments can both face sudden liquidity problems - for example when they become wary of lending to one another, or when tax revenue falls sharply. In these cases short-term credit extension is needed to pay back debt on time and to maintain market confidence. Failure to secure emergency credit can in turn trigger insolvency.

References

- Anderson, Karen M. 2001. The Politics of Retrenchment in a Social Democratic Welfare State; Reform of Swedish Pensions and Unemployment Insurance. Comparative Political Studies, 34; 1063-1091. DOI: 10-1177/0010414001034009005
- Collier, Paul, and Jan Willem Gunning. 1999. The IMF's Role in Structural Adjustment. The Economic Journal, 109; F634-F651. Available at http;//www.jstor.org/stable/2566066 (accessed July 20,2013).

- De Grauwe, Paul. 2011. The European Central Bank; Lender of Last Resort in the Government Bond Markets? CESifo Working Paper Series No. 3569. Available at SSRN http://ssrn.com/abstract=1927783 (accessed July 20, 2013).
- Delpla, Jacques, and Jakob von Weizsacker. 2010. The Blue Bond Proposal. Bruegel Policy Briefs, No. 2010/03 (May). Available at http;//aei.pitt.edu/13911/1/1005-PB-Blue_Bonds.pdf (accessed July 20, 2013).
- Deo, Stephane, Paul Donovan, and Larry Hatheway. 2011. Euro Break-up: The Consequences. UBS Investment Research Global Economic Perspectives. Available at http;//bruxelles.blogs.liberation.fr/UBS%20fin%20de%201%27euro.pdf (accessed July 20,2013).
- Dullien, Sebastien. 2012. Reinventing Europe: Explaining the Fiscal Compact. Available at http;//ecfr.eu/content/entry/ commentary _reinventing_ europe_ explaining_ the_fiscal_ compact (accessed July 20, 2013).
- Featherstone, Keith. 2011. The JCMS Annual Lecture; The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime. Journal of Common Market Studies, 49; 193-217. DOI: 1O.1111/j.1468-5965.2010.02139.x
- Feldstein, Martin. 1997. The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability. Journal of Economic Perspectives, 11: 23-42. DOI: 10.1257/jep.11.4.23
- Goodhart, Charles. 2009. Procyclicality and Financial Regulation. Banco de Espania Revista de Estabilidad Financiera, 16:11-20. Available at http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/09/ May/Fic/ief0116.pdf (accessed July 20, 2013).
- Hall, Peter A. 2012. The Economics and Politics of the Euro Crisis. Germαn Politics, 21: 355-371.DOI: 10.1080/09644008.2012.739614
- Jones, Erik. 2012. Italy’s Sovereign Debt Crisis. Survival: Global Politics and Strategy, 54: 83-110. DOI: http://dx.doi.org/10.1 080100396338.2012.657545

- Lane, Philip R. 2012. The European Sovereign Debt Crisis. The Journal of Economic Perspectives, 26: 49-67. DOI: http://dx.doi.org/1 0.1257 Ijep.26.3.49
- Marsh, David. 2009. The Euro: The Politics of the New Global Currency. New Haven, CT: Yale University Press.
- Moravcsik, Andrew. 2012. Europe After the Crisis: How to Sustain a Common Currency: Foreign Affairs (May/June). Available at http://www.foreignaffairs.com/articles/13 7421 landrew-moravcsik/europe-after-the-crisis (accessed July 20, 2013).
- Paterson, William E. 2011. The Reluctant Hegemon? Germany Moves Centre Stage in the European Union. Journal of Common Market Studies, 49: 57-75. DOI: 1O.1111/j.1468-5965.2011.02184.x
- Reinhart, Carmen M., and Kenneth S. Rogoff. 2009. This Time Is Different: Eight Centuries of Financial Folly. Princeton, NJ: Princeton University Press.
- Sadeh, Tal. 2012. The End of the Euro Mark I: A Sceptical View of European Monetary Union: In Hubert Zimmermann and Andreas Dur, eds., Key Controversies in European Integration, 121-129. Basingstoke: Palgrave Macmillan.
- Shambaugh, Jay C. 2012. The Euro's Three Crises. Brookings Papers on Economic Activity. Available at http://www. brookings.edu/ ~/media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_shambaugh. pdf (accessed July 20, 2013).