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Thoughts about the euro-area crisis*

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Austerity – European democracies against the wall
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As a former member of the Executive Board of the European Central Bank, Lorenzo Bini Smaghi[1] was able to closely follow the impacts of the global financial crisis on euro-area Member States and its transformation into a sovereign debt crisis in the euro area. Ten years after the establishment of the Economic and Monetary Union, the euro area was shaken by a crisis that jeopardised the future of the single currency and the European Union as a whole. In spite of the reinforcement of the European institutional framework (mainly the economic framework), a number of EU summits and crisis meetings as well as the conventional and unconventional interventions by the European Central Bank, the crisis is still unresolved. A complete recovery from the crisis is expected to take years for the euro-area countries, which suffered a serious downturn.

The crisis had a dramatic impact on the economic and social structure of Europe: the increase in unemployment and youth unemployment, the growing number of people living in poverty and the decline in families' income are only a few social and economic consequences of the crisis. In some countries, incomes fell to levels of 20 years ago as a result of the protracted crisis. In Bini Smaghi's opinion, the negative economic phenomena are only the symptoms of a much more serious problem. First of all, the crisis is of a political nature. It reflects that Western societies were unable to solve the problems which accumulated in the past 20 years, and thus drastic steps were necessary during the euro-area crisis to reform the economic and social structures. In view of their future re-election, during their time in office, democratically elected politicians are not willing to take measures

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that would endanger their re-election. Deeper structural changes and reforms have to be waited for until external economic conditions deteriorate to a level where the financial markets are not willing to finance a country any longer. Then the emergency enforces unpopular economic decisions, which most often mean strict austerity measures. This, in turn, hinders economic activity, and threatens political and social cohesion.

In spite of the fact that the global financial crisis did not start from Europe, it still had the greatest impact on Europe due to the complexity of the decision-making mechanism of the European Union. The European Union cannot be considered a complete economic entity similar to the United States. On the whole, power (the co-ordination of individual policies) has not yet moved to the federal level from the local level; decentralisation will take long years, or even decades and will probably be coupled with a serious political crisis.

In the introductory chapter, the author raises six questions, which characterise the decision-making mechanisms of European states.[2] The first question examines the understanding of the global financial crisis and the euro crisis. The most frequently arising and most focussed-on problem during crisis management is the accumulation of debt (whether government or private). Why was the debt level as a proportion of GDP allowed to become so high? This is the result of the imprudent behaviour of banks, households, corporations and the public sector. However, blaming other actors or factors (financial sector, governments, the rich, China, the World Trade Organisation or the euro) may divert attention from the real problems and their efficient management. We also have to ask the questions why financial deregulation was able to create an environment that provided loans too easily, even for non-returning investment or consumption, why public expenditures financed from debt were able to grow faster than incomes, why interest rates were left at a low level for so long, or why the financial supervisory authorities of certain countries were so short-sighted and tolerated high risks. The answer may be that individuals, relying upon past trends, overestimate their future income. However, overestimation of economic growth is more deeply rooted, mostly in the trends in global economy in the past 20 years (i.e. the change in the structure of trade and technological progress), which questioned the growth models of developed industrialised countries and made their social structure unsustainable. Accordingly, the crisis may be understood as a structural crisis, to which there is one possible answer: deeper integration into the global economic system. Therefore, it is no wonder that the downturn suffered during the crisis was smaller for euro-area Member States which had become more deeply integrated into the international system as a result of structural reforms in the labour market and education, coupled

[2] The first five topics are typical of each developed industrialised state, but most seriously apply to EU countries.

with support for research and development as well as investment in infrastructure. By contrast, countries that kept postponing the implementation of structural reforms and whose respective economies were based mainly on the internal market suffered greater losses.

The second problem is the aforementioned continued postponement of politically costly reforms, which is typical of democratic systems. Reforms in certain countries are implemented only when they become necessary in order to avoid a much deeper financial and real economy crisis. A typical example for this is the transformation of pension systems: productivity in developed countries has declined in parallel with the increase in life expectancy. This does not cause a problem as long as the financial markets finance the given state, and the necessary pension reforms are not implemented until then. With a decline in propensity to invest, the risk premium on government securities starts to increase, and as insolvency approaches, the disbursement of pensions also encounters obstacles. And only then does it become clear for the government that the pension system is in need of reform. The third issue is partly the continuation of the previous one. In emergency cases, governments are ready to implement reforms, but due to the short time available they are unable to realise the whole complexity of a problem, and therefore often adopt solutions that are not comprehensive.

The fourth problem lies in the nature of crisis management. Short-term solutions focus on fast recovery from the crisis, whereas long-term solutions aim at preventing the evolution of similar crises in the future. There are serious tensions between the two solutions. The dilemma mainly arises during the treatment of the financial system: to shift the responsibility upon the credit institutions, and the banks that apply a proper lending system will continue to work, while imprudent banks will go bankrupt, or to stabilise the whole financial system and keep lending alive during the period of the crisis as well through government support. In the United States, the bankruptcy of the Lehman Brothers in September 2008 (the lack of government support) triggered a process that resulted in the collapse of the market, and the Congress supported the financial rescue package only after that. The US Treasury recapitalised the major banks in order to avoid a deeper recession. No major bank collapsed in Europe during the global financial crisis; on the other hand, most of the European countries were averse to the recapitalisation of the European banking sector from state funds. This resulted in a gradual weakening of the European financial system and an increase in the risk premia of sovereign states in parallel with bank risks, which prolonged the crisis and terminated lending to the private sector.

The fifth subject matter is a scrutiny of the role of central banks. Central banks face a serious dilemma in the time of a crisis. On the one hand, if they intervene in order to prevent financial turmoil, they reduce market pressure and give time for politicians to implement unpopular reforms, but by that they generate inflation, i.e. they add to the burdens of taxpayers. On the other hand, if they do not intervene, they jeopardise financial stability and price stability as well. This problem is even more complex in the case of the euro area as the debt crisis of certain Member States endangers the functioning of monetary policy and the transmission mechanism of monetary policy. Therefore, the ECB decided to purchase government securities of countries in distress, thus preventing sovereign default and giving time for governments to improve their respective financial positions.

The last topic deals with the problem of the incomplete nature of the euro area, foreshadowing the necessity of deeper integration. *'To overcome the crisis we need more Europe'*, as it has often been mentioned. However, more Europe or deeper European integration requires the delegation of all important components of economic policy to the community level. Of course, this is not supported in EU countries, which is clearly reflected in the strengthening of nationalist parties in European countries, which proclaim less Europe. The problem exists not only at the national, but at the EU level as well, because according to subsidiarity, one of the most important EU principles, a policy may be delegated to community level only if they are unable to exercise it better at national level. In Bini Smaghi's opinion, one or more further crises are needed to convince people that wielding power at the local level is unsatisfactory, and deeper integration is needed.[3]

The author divided the book into 20 smaller chapters, where the aforementioned six problems are discussed in more detail, embedded in the current economic developments in the euro area. The chapters do not present the history of the Economic and Monetary Union in chronological order from its outset to the crisis of the euro area, but describe certain problems that arise. In the individual chapters, the historical presentation is complemented by economic and political considerations.

Alternatives to the Economic and Monetary Union have not proven or could not prove successful. Bini Smaghi presents three possible options that could have been alternatives to the European monetary integration, but their application would also have caused serious economic problems. The first one could have been the further application of the European Monetary System, which followed the collapse of the Bretton Woods system, but the widening of the fluctuation bands with the crisis of the European Monetary System would have caused serious tensions in trade. Moreover, it would have jeopardised the functioning of the single internal market. The second option would have been the strengthening of monetary stability around the German mark, but the Bundesbank was responsible only for the stability of

[3] This thought of Bini Smaghi coincides with the idea according to which European economic integration is reactive, and deepening only takes place if a response to some crisis is needed. The lack of proactive attitude is negligible in crisis-free periods, in the case of economic prosperity.

the German mark and not for other currencies. The third option could have been the establishment of an 'exclusive' monetary union, which would have torn the then European Union into two. Consequently, there remained no other solution but to establish the Economic and Monetary Union on the basis of the Delors Report, which is the clear consequence of creating the single internal market (with guaranteeing the condition of free movement of capital). Markets cannot become completely integrated until there are different currencies, but without the integration of the markets the monetary union cannot be considered an optimum currency area. The only remaining question is whether it would have been better to postpone the launching of the monetary union.

The launch of EMU has made it clear that this is a one-way process; it is not possible to step back from a deeper stage of integration to a lower stage. Greece's exit from the euro area has been on the agenda in political and academic circles for years, but it does not even have any legal basis.[4] As a result of an exit either a dual currency system should be applied or a new currency should be introduced (return to the earlier one), but both steps would have serious economic consequences: the exiting country would be unable to finance itself from the international markets, euro-denominated government debt would increase considerably, and the country – Greece in this case – would have to face a much more serious economic recession.

In the presentation of the crisis, Bini Smaghi mentions that (when the book was written) three countries in a crisis (Greece, Ireland and Portugal) became insolvent due to completely different circumstances. Spain and Italy also faced serious economic difficulties, which were alleviated only by the OMT announcement. However, during this time, 'Northern' or core states did not suffer any strong economic downturn. This was mainly attributable to the fact that for example Germany in the 2000s, although with difficulties, but implemented the structural reforms that significantly improved its international competitiveness. In the author's opinion it was of crucial importance. Competitiveness as a key factor is mentioned several times in both the Introduction and some chapters. Firstly, the countries that implemented the necessary reforms did not suffer any material downturn. Secondly, their labour cost based competitiveness improved considerably, contributing (through exports) to these countries' recovery from the crisis.

Bini Smaghi devotes several short chapters to the foundation of new institutions. The European Stability Mechanism, aka the European Monetary Fund, was an important factor to calm down financial markets. The establishing of the Banking Union is a necessary condition for a deeper European monetary integration, as excessive lending by banks and their insufficiently strict regulation constituted

[4] Based on the Treaty of Lisbon, it is possible to withdraw from the European Union, but not from the euro area.

one of the underlying reasons of the crisis. With their community regulation the European banking sector may become more integrated, and it may also handle the relationship between bank risks and sovereign risks. In addition, he emphasises the crisis management by the European Central Bank as well as its unconventional instruments that have allowed and may allow time for individual governments to implement the necessary adjustments and reforms.

In the Summary, he presents his own comments on the future of European economic integration in four points. The first one outlines the incompatibility of European economic models. He states that the current economic models are inadequate in the new global context, and structural changes are necessary. The second one is about the independence and supervision of institutions, which may provide basic input on formulating individual national economic policies. The purpose of this is to avoid an overestimation of future economic growth to an extent typical before. The third one underlines the national fiscal framework, supports the idea of the fiscal pact, in which the planning of national fiscal policies is carried out for the medium term, and the reduction of government debts is an essential objective. Finally, demographic problems are focussed on. Economic decisions related to the issue of ageing should not be postponed, and temporary or incomplete short-term adjustments should not be made.

Lastly, the difficulties ahead of us might seem insoluble, but the past 60 years of European history have shown that any problem can be overcome. There is still a long way to go, but even the United States was not created in a day; not even in a century.