# The eurozone crisis may need to get worse before it can be solved

Blog Admin

*The eurozone is facing a complex competitiveness, fiscal, banking and political crisis.* **Miguel Otero-Iglesias** *writes that the fundamental problem is that the countries of the eurozone are unwilling to hand over sovereignty to an EU centre. He argues that the significant political obstacles to reform may mean that the crisis will have to get worse in Spain, Italy, and even Germany before European leaders will take the bold steps needed to ensure the survival of the euro.*

"It seems that we need more trouble in the eurozone periphery before we see bold political steps toward solving the crisis." This statement by the LSE's Waltraud Schelkle is a good summary of the content of a recent LSE conference on the eurozone crisis that we organised at the Centre for International Studies. During the event, experts discussed the role of Germany in the crisis and the possibility of a fiscal and political union in Europe.

Generally, the consensus among the participants was that we are dealing with a complex, multidimensional problem that can be divided into a competitiveness, fiscal, banking and political crisis. Clemens Fuest, of the University of Oxford, for example, focused his attention on the competitiveness problems of the eurozone periphery in an increasingly globalised world. He acknowledges that there has been a certain rebalancing between the eurozone periphery and the core since the beginning of the crisis, but for him, with the exception of Ireland, the improvements in Greece, Portugal, Spain and Italy have been minor. The reductions in unit labour costs and current account deficits in these countries appear to stem from high unemployment and lower wages and massive cuts in imports, rather than from an improvement in productivity. Furthermore, Fuest warns that if the current pattern of negative growth and relatively high interest rates in sovereign debt markets persists, several of these countries might join Greece in becoming insolvent.

The LSE's Luis Garicano, on the other hand, offered a comprehensive analysis of the Spanish banking crisis. In his opinion, a eurozone banking union is absolutely necessary to break the diabolic feedback loop between sovereigns and banks. In this regard, he criticised the recent decision by the ministers of finance of the creditor countries to exclude legacy debt from the prospective banking union arrangements. He maintains that if the Spanish state has to fully guarantee the debt of the Spanish banking system it is unlikely to see Spain becoming attractive for foreign investors because they will fear huge tax burdens in the future. As the LSE's John Ryan pointed out during the discussion: "where there are irresponsible debtors, there are irresponsible lenders." Therefore, it seems only logical that some of this legacy of debt will have to be mutualised to share the huge adjustment costs that are taking place.

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The Peterson's Institute's Jacob Kirkegaard explained why, so far, the adjustment has been happening in the eurozone periphery. In his opinion Germany has been quite successful in using the effects of the crisis to its own advantage. Using the 'game of chicken' metaphor, he made a compelling case that Germany, since the early stages of the crisis, had realised that the impact would be asymmetric. Thus, they came to the conclusion that the periphery will blink first in the battle between more solidarity and more centralised control of national budgets. The fundamental problem is that the eurozone countries are not willing to hand in their sovereignty to the centre. Until this is the case, the crisis will persist, and Germany will not move.

Of course, the history of monetary unions, the state theory of money and the optimum currency area (OCA) theory support Kirkegaard´s argument. A currency area can only survive if it has a centralised political authority to underpin it. Even Benoit Coeure, one of the ECB's permanent executives, has recently accepted this logic. His words are significant because this is the first time that a high profile policymaker at the ECB has moved away from the orthodox understanding of money as a neutral medium of exchange and engaged with the state theory of money.

So is the only solution to the crisis a United States of Europe? Heribert Dieter, of the German Institute for International and Security Affairs, argues that this would be a huge mistake, which is a thought that is increasingly shared among European scholars. European societies are too diverse and divergent to be managed by a centralised power. In Dieter's opinion, the European public would be against this move, especially the German population. This is the reason why Angela Merkel has never attempted to sell her vision of Europe to the German electorate. Her political union idea is just too unpopular, at least for the moment (although, perhaps it is so unpopular precisely because she has never dared to explain it). She might be able to push through a federalised or decentralised (German dominated) banking union because this is a technical area, and it seems that this move is economically indispensable for the survival of the euro, but political union is a non-starter with the German public.

The question though is can the eurozone have a banking union with a resolution fund and a deposit insurance scheme without a political union? Having a single banking supervisor has major implications. Who will determine how the ECB´s supervision needs to be executed, under which guidelines and with what kind of democratic legitimacy? Banking union, with all its economic and political implications, might be seen as a fiscal union through the back door. No wonder Germany is starting to have cold feet on this particular topic. As Waltraud Schelkle points out, since Mario Draghi came out in July 2012 with his ground breaking speech on the irreversibility of the euro and his determination to do whatever is required to save the single currency, which then led to the Outright Monetary Transactions (OMT) programme, creditor countries have slowed down progress on the banking union and debtor countries have shied away from asking for a rescue programme. It seems that we need more trouble in Spain or Italy to move toward further economic and political integration. Perhaps the economic situation in Germany needs to worsen for the German government to launch a new stimulus package like in 2009.

This shows that the eurozone is becoming the world champion in piecemeal solutions and muddling-through. Gabriel Glöcker, from the ECB, laments this situation. He has argued that the markets demanded a comprehensive reform package in eurozone governance. This is actually what has been delivered but, because it has been agreed incrementally after long negotiations and consensus-building, it has been much less successful in generating a positive market dynamic.

Nevertheless, one should not underestimate the progress that has been achieved. Some of it would be unimaginable only three years ago. The eurozone now has a permanent rescue mechanism, the ESM (a de facto European Monetary Fund), which has the capacity to intervene in the secondary and primary sovereign debt markets and can also inject funds into national banking systems. Eurozone member states have signed the six-pack, the two-pack and the fiscal compact, which will be enshrined in constitutional law or similar. They have also agreed to hold regular Eurogroup meetings at heads of state and government level. In exchange, the ECB has expanded dramatically its non-conventional tool box with the Securities Market Programme (SMP), the Long Term Refinancing Operation (LTRO) scheme and the previously mentioned Outright Monetary Transaction (OMT) programme, which aims to strike the right balance between solidarity, conditionality and the avoidance of moral hazard. On top of this, the four presidents (European Council, European Commission, Eurogroup and ECB) are working on a 'genuine economic and monetary union' framework and the member states are currently negotiating the creation and implementation of a banking union.

This is a lot of institutional change in a relatively small amount of time by European standards. Unfortunately, it is still not enough to solve the crisis. There are still many open questions on how to deal with legacy debt; on what kind of banking union will be created; on how to reignite growth; whether it will be necessary to have a centralised eurozone budget and mutualisation of prospective debt, and consequently whether we will one day have the equivalent of a eurozone minister of finance, with the democratic legitimacy to shape and control national budgets.

There is no doubt that there are huge political obstacles preventing these moves from happening, hence perhaps the sad truth that comes out of our discussions is that things might have to get worse before the European leaders take the bold steps that are necessary for the euro to survive. In this regard, Kirkegaard quotes Wolfgang Schäuble, the German Finance minister: "When things get really difficult… suddenly solutions which seemed impossible become possible…Sometimes you need a little pressure for certain decisions to be taken". It seems that we will have to wait for this little pressure.

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*Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics*

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