The issue : Could the euro destroy the EU?

Our verdict: Only "more Europe" can avoid a deeper crisis

It's not just the eurozone that's in danger, but the European Union itself, say Kemal Derviş and Javier Solana. They argue that only the emergence of a European "political space" and further sharing of sovereignty can overcome the crisis

The European project has had to overcome many difficulties in the past, but the challenges it will face in the next two or three years are going to be momentous. Not only the eurozone but the European Union itself is in danger.

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Even in a worst case scenario, some areas of intra-European co-operation will surely survive. But it is hard to see how the EU as we know it today could survive even a partial disintegration of the eurozone. The sense of failure, the loss of trust and the damage that would be done to so many if two or three countries had to leave the eurozone would be of a magnitude to shake the entire Union.

Nobody can foresee exactly what the dynamics would be, or how finance and trade could cope, and more important still what the political fall-out would be. Those who argue that one or more countries in the periphery should take a "holiday" from the euro underestimate both the economic and political repercussions this could have.

Resentment has already built up between the "North" and the "South", and it could get much worse. The European Union has been built by incremental steps towards greater integration and co-operation. Overall, these steps were perhaps slow, and certainly they were often complex, but they were successful. There was a sense of momentum, of the strength of soft power, and of progress that was almost inevitable.

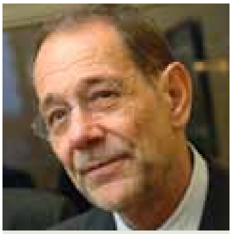
All this has been shaken by the crisis that started with Greece, spread to other peripheral countries and continues to challenge the sustainability of the monetary union, and through that, the EU itself.

The difficulties that now face the eurozone have a number of interconnected dimensions. The one that was most apparent right from the start was the loss of confidence in Greece's sovereign debt and then of other peripheral countries. A good example of just how quickly market sentiment can shift was the way the spread Greece had to pay over German bonds exploded from very little back in 2009 to hundreds of basis points in less than two years. The Greek crisis suddenly made it very clear to the markets that there was a fundamental difference between eurozone sovereign debt, and U.S., Japanese or UK sovereign debt; the individual countries making up the eurozone no longer had national central banks capable of printing money to stop a run on their sovereign debt.

The European Central Bank could technically play that role, but not only did it not have to play that role but also it seemed legally barred from doing so. That turned Greece, Portugal, Ireland, Spain and even Italy into typical developing countries undergoing a debt crisis, as had happened elsewhere so often in the 1980s and 1990s. Ireland, too, became a problem country, although its difficulties being entirely due to the banking sector set it somewhat apart.

Developing countries have of course had national central banks capable of printing domestic money, but their currencies were not reserve currencies, so while a developing country could try to pay for its domestic debt by printing money, it could not do so for its foreign debt, in contrast to the U.S., Japan and the UK, whose monies are reserve currencies that foreign governments, institutional investors and even private citizens are willing to hold at reasonable interest rates.

The peripheral eurozone countries were thus left without such cover, and that was at the heart of the crisis until the European Central Bank (ECB) finally intervened with sufficient heft at the beginning of November 2011. It didn't do so by directly buying massive amounts of peripheral debt, but by offering a trillion euros of liquidity to the European banking system with three year maturity at a 1% interest rate and with liberal rules as collateral.



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The ECB's massive liquidity provision was a clever and necessary move because it was able to reduce indirectly not only the pressure on sovereign debt, but also the second dimension of the eurozone crisis: the perceived weakness of many European banks.

Some of that weakness was linked to the aftermath of the financial sector's sub-prime mortgages crisis imported in 2008 from the United States. But much of it was quite simply a reflection of the euro-periphery's sovereign debt crisis. Essentially, the sovereign debt and the banking crisis were two sides of the same coin as most European banks held large amounts of peripheral eurozone debt on their balance sheets. A decrease in the value of that debt threatened the capitalisation of these banks. Commercial banks in the peripheral countries of course held large amounts of their own government's debt, so many of them were therefore particularly vulnerable. This vulnerability of peripheral countries' banks added a further dimension of risk to the European banking crisis.

European banks also need more capital now because of the greater stringency of the Basel III capital adequacy requirements that are to be phased in from 2013. But the main reason for their re-capitalisation will be the lower value of peripheral countries' sovereign debt if and when they have to show these losses on their books.

How great the banks' re-capitalisation needs are going to be will depend crucially on how the value of sovereign debts evolves. As the sovereign debt and banking crises are so closely inter-linked, the weaker a bank is the less will be its willingness to hold or buy peripheral sovereign debt. By the same token, the lower the value of peripheral sovereign debt, the weaker will these banks be and the greater their need for capital.

The ECB has moved to relieve the pressure coming from both problems. The banks are being provided with almost unlimited liquidity, which gives them time to try to restructure and find enough capital. At the same time, some of that liquidity is being channelled into buying peripheral sovereign debt, given the very high spreads compared to the cost of the ECB's money at 1%. Spanish and Italian banks in particular have bought a lot more of their own country's sovereign debt.

It should be noted, though, that compared to the purchasing of debt by the ECB itself, the commercial banks continue to carry the sovereign risk on their balance sheets. Neither the underlying creditworthiness of the sovereign borrowers nor the capitalisation of the banks is "solved" by these ECB credits, but both the sovereign debtors and the banks are given time to take more fundamental measures.

The third and most difficult dimension of the challenge faced by the eurozone is the difference in production costs and competitiveness that has accumulated over time and is reflected in the substantial current account deficits of the "problem countries". Unit labour costs in Greece, Portugal, Spain and Italy grew between 20-30% faster than in Germany, and faster than unit labour costs in Northern Europe as a whole. This was due to both differences in productivity growth, and even more to differences in wage growth. The inflows of capital into the South, broadly speaking, led essentially to a real revaluation and a lowering of the domestic savings rate relative to investment, resulting in structural current account deficits in the balance of payments.

In Greece, large fiscal deficits accompanied and exacerbated this process, but the situation was very different in Spain where the counterpart of the foreign inflows was private sector borrowing. The eurozone crisis will not be resolved until this internal imbalance is reduced to a point where it becomes sustainable.

There's no need in the long run for every eurozone country to run a balanced current account. Some countries can in principle finance some of their investment with foreign savings. Over the remainder of this decade, however, the peripheral countries will not have much room for substantial current account deficits as they must reduce not only public but also private debt in relation to their GDP.

There is therefore a need not only for fiscal adjustment, but also for an adjustment in the balance of payments. To facilitate this adjustment there is need for a real exchange rate adjustment inside the eurozone, with production costs in the peripheral problem countries falling relative to the costs of production in the countries of the "broad North", Germany being by far the largest.

Real exchange rate adjustments inside a monetary union, or among countries with fixed exchange rates, can take place through differentials in the rate of inflation. The real value of the Chinese Yuan, for example, has appreciated considerably compared to the U.S. dollar, despite very limited nominal exchange rate changes because Chinese domestic prices have risen faster than prices in the United States. For a similar adjustment to take place within the eurozone, assuming similar productivity performances, wages in the peripheral problem countries of the South must rise more slowly than in the North for a number of years, thus restoring their competitiveness.

With the overall eurozone inflation rate targeted at 2%, and with Germany and the other northern surplus countries behaving as inflation hawks, pursuing policies that keep their own inflation close to the eurozone target, the real exchange rate adjustment inside the eurozone requires actual wage and price deflation in the southern problem economies.

This pressure on the peripheral countries to deflate their already stagnant economies is turning into the eurozone's greatest challenge of all. The ECB's provision of liquidity has bought time, but cannot solve the overall problem. But unless real adjustment takes place, the eurozone cannot be cured of its ills.

The required real adjustment could be achieved with less real income losses and wage declines if productivity in the peripheral economies were to start growing significantly faster than in the North, thereby allowing prices to fall without wages having to fall. Structural reforms could undoubtedly lead over time to an acceleration of productivity growth, but this is unlikely to happen in an environment where investment faces deep cuts, where credit is severely constrained, and where many young people with skills emigrate.

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Price deflation is in any case not very conducive to bringing about the sort of relative price changes that could accelerate a reallocation of resources. It is much easier to change relative prices when there is modest inflation than when these changes have to be achieved by actual nominal price reductions. The need for better productivity performance in the problem countries is undeniable; yet achieving such an improvement in the present climate of extreme austerity and deflation is very unlikely given the atmosphere in them of either latent or open social conflict.

These economic adjustments would become much easier if the eurozone as a whole were to pursue a more expansionary policy “on average”. If the target inflation rate for the eurozone were to be set temporarily at, say 3.5%, and if the countries with surpluses in the current accounts of their balance of payments encouraged domestic inflation rates somewhat above the euro-zone target, then there could be real internal price adjustment inside the eurozone without actual price deflation in the peripheral problem countries.

This would and should be accompanied by an overall depreciation of the euro. Such a "softening" of the dilemma, to be achieved by targeting a somewhat higher inflation rate in the eurozone, is not a panacea. Courageous structural reforms would still have to be pursued in the peripheral countries, and indeed throughout Europe. High public debt levels would still have to be reduced to create fiscal space and keep interest rates low so as to restore long term confidence. The eurozone would still need to strengthen its firewalls as well as its mechanisms for co-operation. But a temporarily and modestly higher inflation rate would facilitate the process of adjustment and give reforms a chance to work.

Deflation is not conducive to optimism and a sense of a better future. Putting the whole burden of adjustment onto the countries of the South with current account deficits, while the North continues to run current account surpluses, would actually obstruct adjustment. Letting the "magic" number of 2% inflation determine the overall macroeconomic framework is irrational. If lower is always better, why not set the target at 1% or even zero? There are times when 3-4% is better than 2%, and Europe is at such a moment.

Beyond any economic analysis of the eurozone's problems there lies the deeper question of what kind of Europe is now politically feasible. Truly co-operative economic policies require truly co-operative European politics.

First, it is clear that if the eurozone survives it will not include the whole EU but will continue to be just part of an EU that for the foreseeable future will exclude the United Kingdom and perhaps a few other countries. There is therefore the great challenge of defining the future of the relations between the eurozone and the UK. It's going to be a crucial aspect of the EU's future, but is also beyond the scope of this essay.

Second, the closer co-operation inside the eurozone that is essential for its survival will as of right now require more integration and harmonisation, particularly in fiscal policies and financial sector supervision and regulation. Temporarily breaking up the eurozone by allowing some countries to take "vacations", would be economically and politically much more disruptive than the proponents of this view seem to realise. Even finding the legal means to do so without completely wrecking the EU treaties would be a major challenge. These would be vacations from which the holidaymakers would probably never return.

But integration means more sharing of sovereignty in matters close to the core of the nation state. That will not be a trivial exercise and is why Europe is at the cross-roads. Either it moves ahead with greater sharing of sovereignty, or it may well disintegrate. Key to success is that this sharing has to take place through transfers of sovereignty to accountable institutions. The legitimacy of the operation has to be achieved through a democratic process. For legitimacy, citizens must have the feeling that the institutions that govern them account for their interests and make them part of the decision-making process, which implies a union based on rules rather than power. The present situation is increasingly perceived by public opinion as one where a reduced number of countries – sometimes only one – seem to chart the EU's future without any referral to a pan-European political process. Such sentiments are likely to make the whole process of co-operation unsustainable.

The fact that the EU does not instantly have all the answers to its problems does not mean that it has no future. The EU is and will continue to be an experiment which, as with all experiments, entails a degree of uncertainty. The search for solutions cannot just be technocratic but must be embedded in a truly pan-European democratic discussion.

Interdependence in Europe, with its many dimensions, is now well established. And future economic and social dynamics will pull further in that direction. To try to adhere to a narrow Westphalian concept of sovereignty would in today's world be at best an anachronism and at worst a dangerous gamble for any EU country that must exist in the global economy and be part of the international community.

For those countries that are part of the already highly integrated eurozone it is even more impossible. Legitimacy and democratic consent will require that states and their citizens give up some of their sovereignty to institutions based on the equitable sharing of that sovereignty, rather than to a group of countries representing current creditor status or economic might.

The sharing of sovereignty has of course to recognise the relative weight of countries, and reaching agreement on these weights is a very difficult process. Inter-governmental decision-making processes have of late had the upper hand in Europe and will no doubt continue to play an important role. But unless they are complemented by the emergence of a European political space which backs European institutions built on further sharing of sovereignty, neither the eurozone nor the European Union is likely to overcome the current crisis. ■

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