EU Economic Solidarity: A Great Leap Forward or a Bridge too Far? [1]

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May 2010 will go down in history as a major watershed for the European Union. First, the €110 billion loan to save Greece from default; then the massive €750 billion loan guarantee mechanism designed to stop the contagion from Greece's sovereign debt crisis infecting other weaker European economies. With these actions, the EU took an unprecedented great leap forward, representing a new kind of economic solidarity among the member-states. But for this not to be a leap into the void, the EU now needs to do much much more. It must rethink its approach to economic governance by coming up with better criteria and oversight along with more coordinated action to promote sustainable growth while calming the markets. For this it needs not just greater economic solidarity but also social solidarity, to deal with rising unemployment, poverty and inequalities. And all of this in turn demands real political will – to deepen economic integration even where this undermines national sovereignty – and political leadership – not only to pursue these initiatives but also to legitimize these at a time when inward-looking politics, not to say nationalism, is on the rise. The question is: Are these next steps a bridge too far for the EU?

This great leap forward itself came at the very last minute after much hesitation and tremendous delay. Had the intervention come when the Greek crisis first arose, the markets might have been reassured, although this might still have only briefly put off the attack on the other weak Southern European economies. There was, in other words, always the need for some kind of collateral loan guarantee mechanism or financial lending institution of last resort – better, a European Monetary Fund (EMF) equivalent of the IMF – to deal with the problem.

But it would have actually been even better had a European Monetary Fund covering the entire EU been set up much sooner, arguably already when the Central and Eastern European countries were in danger of default in 2008. Had the EU signaled to the markets that it would take care of its own rather than send them to the IMF, this might have been sufficient to avoid the whole sovereign debt problem in the first place. Instead, the member-states retained the principle of "every man for himself", refusing to create a bailout for the East European countries in response to the cri de coeur of the Hungarian Prime Minister against the creation of a new economic iron curtain, arguing that this would create "moral hazard" if countries believed they would be bailed out for their bad debts and overspending.[2]

Point taken. But leaving the bailout to the IMF instead created a "market hazard", with the development of an entire market betting against the EU rescue of any of its member-states from sovereign debt default once further vulnerability was detected. It is also led to tremendous hardship for the Eastern European countries that went to the IMF for help. At a time when the rest of Europe, and in particular the richer countries, were encouraged to spend, spend, spend to avoid recession and maintain employment, East Europeans in trouble were plunged into deepening recessions and rising unemployment.

Now Greece under EU prescription and the other Southern European countries on their own are preparing to engage in the same recession-promoting, growth-destroying economic exercise – with the additional risk of political instability and civil unrest. And this is at a time when they are already paying the price for their perceived weakness, as governments pay higher interest rates on their bond issues and even profitable businesses find credit scarce.

1 First published in German in the Neue Gesellschaft-Frankfurter Hefte (June 2010).

2 Schmidt, Vivien A. (2009) "Re-Envisioning the European Union: Identity, Democracy, Economy," Journal of Common Market Studies 47 Annual Review: 17-42.

It should therefore come as no surprise that the value of the Euro in the currency markets, which bounced back briefly in response to the loan guarantee instrument, quickly slid on worries not so much about whether Southern European countries would stick to budgetary austerity as about what such austerity would do to European growth generally.

So the first big question for the EU is: how to promote growth? Going back to the same old restrictive numerical targets of the Stability and Growth Pact (SGP) – that countries have honored more in the breach – is not the answer. Nor is imposing balanced budget rules and other draconian measures on Eurozone members – such as withholding EU funding from "profligate" members who disobey the rules, as Germany proposed.

Credibility of the Eurozone was maintained not because of the Eurozone's notionally hard but practically soft criteria. Rather, it was because of positive market perceptions of ECB monetary governance and of the economic fundamentals of the Eurozone countries as a whole. In this regard, it is important to remember that the problem for Europe started not with public debt – governments with the exception of Greece were for the most part fiscally responsible throughout this period, while Spain actually reduced its public debts significantly. Rather, it came from private debt (of household and financial institutions) – such as the housing bubbles in the UK and Spain – and the crisis sparked by banks' losses in the US subprime markets, that governments then made public through loans, guarantees and outright nationalization of the banks in their efforts to avoid catastrophe. Restrictive macroeconomic policies therefore would do a lot to punish countries for problems that are not entirely of their making while doing little for growth, which is likely to be promoted more effectively by enhancing competition and combating corruption, boosting productivity through worker training and re-skilling and reforming labor markets.

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At a time when the markets are able to shift their concerns from stability to growth, why should not the masters of the Euro? To do so, the EU needs to find a more flexible approach to economic governance that deals with the differences among its member-states' models of growth and competitiveness and addresses the specific weaknesses in the different countries. This requires a much more finely-tuned economic governance in which the Commission, instead of evaluating countries separately and solely on a narrow range of numerical macroeconomic indicators, would need to consider the interplay of all the member-states' economies. For individual countries, moreover, the EU could set more realistic and flexible targets for deficit, debt and inflation depending upon its needs and prospects for sustainable growth within the context of its specific model of competitiveness. And it could and should evaluate those prospects by considering the full range of economic factors that make for growth and stability – productivity , unit labor costs, employment rates, consumption, deficits, business profile and current account surpluses.

But more may be necessary, in particular for member-states in dire straits, in need of support through the loan guarantee instrument mechanism. Here, the EU needs to think the hitherto unthinkable – by allowing a "structured" debt restructuring and/or currency devaluation via a limited move out of the Eurozone into the European Monetary System, protected by the loan guarantee mechanism that would allow it to borrow from that mechanism rather than the markets until it recovers and returns to the Eurozone. A similar such arrangement could be made for the non-Eurozone members.

Most economists predict that Greece will need to restructure its debt sooner or later – so why not do this in a way so as to restore Greek competitiveness and reduce citizen pain? This would also, however, mean that the European banks most exposed – notably French and German banks – would also have to take "haircuts", and might even require government intervention to ensure against another major banking collapse. But this also speaks to the more general need for European banking reform as well as for real regulation of the financial markets.

So far, we have only talked about an "automatic financial solidarity mechanism" for member-states, through the collateral loan guarantee mechanism or a European Monetary Fund. But the EU also needs an "automatic social solidarity mechanism" to address the rising inequalities within member-states as well as between them, in particular as a result of rising unemployment and deteriorating social welfare programs. For the EU to live up to its claims to promote "Social Europe", it would need at the very least to raise the level of the European Social Fund and the Globalization Adjustment Fund. Where could the money be found? I suppose it is politically impossible to do the most obvious, to convert the Common Agricultural Policy into a minimum income support for the poorest EU citizens. But failing that, why not use a portion of the proposed Tobin-like tax on financial market transactions, currently focused solely on providing insurance against banks "too big to fail", to address poverty reduction – which can easily be legitimated on the grounds that citizens have taken over the banks' bad paper. Alternatively, why not create a European solidarity tax taking at first, say, ten Euros per citizen collected through national income tax, and use it to replenish the Globalization Adjustment Fund to deal with unemployment and inequalities resulting from the euro crisis?

For any of these suggestions to succeed, however, the final challenge is political. There needs to be the political will to build deeper economic solidarity, including the willingness to give up more national sovereignty with regard to economic governance – and real political leadership to forge agreements among the member-states as well as to build citizen support. Moreover, this needs to be done in a way that enhances rather than reduces democracy and legitimacy in the EU.

The current manner in which the Commission envisages deeper economic governance relies on the same technocratic approach to economic governance that some have long decried as an attack on national democracy and sovereignty because decided and carried out by unelected bureaucrats. This is one of the clearest examples of the EU's "policy without politics", in which policies that are normally the basis for politically charged debates on a left/right basis have been removed from the national to the EU level, where they have become the subject mainly of interest-based and technocratic debates. This in turn has left the national level increasingly as "politics without policy", with the national public sphere more and more impoverished as some of the most politically salient issues have been moved upward to the EU – resulting concomitantly in citizens' sense of loss of national democracy and their questioning of the EU's legitimacy.[3]

There is another way of creating such European economic governance, however, which could be an opportunity for enhancing democracy through greater "policy with politics" at both the EU and national levels. The process could be as follows: The Commission proposes overall guidelines for member-state budgets on a yearly basis that the Council would debate and decide in conjunction with the European Parliament (EP) and in consultation with the European Central Bank. (This could also be an opportunity for the EP to use the procedure of consultation with national parliaments introduced in the Lisbon Treaty.) These overall guidelines could then be translated into more refined recommendations by the Commission or a separate expert body on the basis of member-state governments' proposed budgets – which national parliaments would then take into account as they debated and voted on the national budget. All of this would make for more focused national debates that would take account of EU-related

3 See Vivien A. Schmidt, (2006) Democracy in Europe: The EU and National Polities Oxford: Oxford University Press.

issues and concerns, thereby generating an on-going public discourse that could lead to greater EU legitimacy as well as a sense of Europe-wide economic solidarity. And this kind of democratic budgetary governance, added to better and more flexible oversight, would make for more realistic, responsible and sustainable national spending patterns that would be more likely to promote economic reforms for sustainable growth as well as stability.

The main obstacle that stands in the way of this more democratic, pro-growth approach to economic governance in Europe is, somewhat surprisingly, Germany. The problem is that German leaders have backed themselves and the country into a corner by the way they have been speaking about and dealing with the crisis since the very beginning.

Chancellor Merkel in particular can be singled out for stonewalling on Greece, hoping that it would tighten its own belt sufficiently to calm the markets and that she could win North Rhine-Westphalia first in the May 9 election. Instead, the crisis got much worse and she got a drubbing in the regional election, losing her majority in the upper house. In the meantime, Merkel's discourse, by following rather than seeking to lead public opinion, made it very difficult for her to legitimate her about-face on the Greek loan, let alone the loan guarantee or any future positive action. Her discourse was all about punishing the Greeks and ensuring the most restrictive adherence to the Stability and Growth Pact. This fueled a nationalistic, media feeding frenzy that opposed any bailout because it would make "good" member-states' liable for the debts of "bad" ones, that emphasized the virtue of good Germans who saved, tightened their belts through budget-cutting and wage-restraint, and that opposed any "transfer union", in which Germans would underwrite the irresponsible South. How then to legitimate her reversal of position first on the Greek loan and then, under pressure for other member-state leaders in the negotiations as well as from Obama, on the loan guarantee? On national TV, all Merkel did was to offer a very thin, economistic discourse that claimed that "the future of Europe depended on it" and "it was essential to maintain the stability of the Euro." This was followed by her government's push for the most rigid interpretation of the Stability and Growth Pact and serious punishment, including loss of voting rights, of offending Eurozone members. Is this what the EU needs to return to sustainable growth and stability? Will this convince the markets? Not likely.

What the EU needs is forward-looking leadership that can build more growth-oriented economic governance while articulating a legitimating discourse that convinces its citizens as well as the markets of its benefits. Europe cannot do this without Germany. But Germany, for the moment, does not seem willing or able to do this for Europe.