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BEYOND MAASTRICHT: A NEW DEAL FOR THE EUROZONE

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SUMMARY

Europe's Economic and Monetary Union has been an extraordinary achievement. But the events of 2010 have made it apparent that its political governance was designed for fair weather. Having reluctantly taken the first steps this year, European leaders must now make it storm-proof. The move to an agreement to establish a permanent European Stability Mechanism (ESM) to replace the EFSF in 2013 represents a fundamental and encouraging change in the approach of European leaders to the future of the eurozone. But the new model of eurozone governance currently envisaged by the EU, which is based once more on the Maastricht Treaty, will be vulnerable to failure for the same reasons as its predecessors.

If Europe wants to remain a serious player and help shape the twenty-first century, it should instead go beyond Maastricht and finally build a monetary and economic system strong enough to last. There are at least three other solutions – Eurobonds, a euro-TARP and an expansion of the federal budget. Yet each of them is opposed above all by Germany, the eurozone's dominant power, which feels its robust growth vindicates its own economic model even though its political model for a rule- and sanctions-based governance of the eurozone looks to have failed. Europe now faces a choice between a future of permanent tensions within the EU and a new grand bargain. Europe needs clearheaded, forward-looking German leadership that would anchor a European Germany in a more German Europe.

Six months after European leaders took decisive action to avert an imminent financial collapse of European and global markets, it is clear that they have failed to do enough to stop the contagion. Having already bailed out Greece, they agreed – on the 60th anniversary of the Schuman Declaration, in May 2010 – to create, together with the IMF, a massive €750 billion rescue package to deter speculators or, at worst, to assist other eurozone countries in dire budgetary straits. But despite this bold move – and decisive but socially and politically costly action in many eurozone countries to cut deficits – the crisis has resumed and deepened. A summer of uneasy calm was followed in the autumn by a dramatic fresh loss of investor confidence in eurozone sovereign debt. In November, Ireland became the first country to request assistance from the European Financial Stability Fund (EFSF) that EU leaders created in May.

A domino effect now threatens to move from the periphery to the core. If Portugal falls, as many expect it to, the fourth-largest economy in the eurozone, Spain – whose GDP of €1 trillion is seven times larger than Ireland's and represents a tenth of the eurozone economy – could be next. Unlike Greece, the markets' first target, Spain did not go into the crisis with a large public debt problem and it is threatened above all by the extent of financial sector losses. Even if EFSF funds were sufficient, as authorities insist, a rescue operation for Spain would mark a dangerous new turning point in the sovereign debt crisis. If Spain – a major European country with global reach – were pushed towards intervention or insolvency, the impact would be disastrous. In the worst-case scenario, it

could be followed by Belgium and Italy, both of which are more heavily indebted than Spain.

The EU has been in crisis before. But this time it is different. In the past, Europe's leaders drew on the lessons of two world wars and seized crises as opportunities to deepen political and economic integration. In the 1980s, Europe answered the threat posed by the superior performance of the US and Japanese economies with a decision to complete the single market. In the 1990s, it responded to the fall of the Berlin Wall and German reunification with the creation of a monetary union. Now, faced with a crisis that has exposed the weaknesses of its eurozone governance, the logical next step would be to strengthen economic union in the spirit of Europe's founding fathers. "Europe will not be made all at once, or according to a single plan," Robert Schuman declared in 1950. "It will be built through concrete achievements which first create a de facto solidarity."¹

But while the ECB takes the lead in fighting the crisis, Europe's national leaders dither. Since the beginning of the crisis, they have seemed to move only when overwhelming market pressure left no alternative, as when they created the EFSF on 9 May. The main reason is a fundamental change in the position of Germany at the core of the European project. For 50 years, Europe has been the scene of fierce competition between diverging economic models. Buoyed by uniquely strong growth amid the biggest economic and financial crisis since World War II, Germany feels it has won this battle even as its huge trade surplus creates damaging imbalances within and beyond Europe. Having itself completed painful reforms, it sees no reason to spare other countries this discipline. In the past, the process of European economic integration was driven by compromises between member states and, essentially, between France and Germany. Now, however, it hinges on other member states agreeing to adopt the German model of trenchant reform and fiscal restraint. France's gradual retreat into silence is as telling as the change in perspective is profound: from a European Germany to a German Europe.

As European leaders publicly quarrel about the way forward, despite engineering converging budget cuts at home, they strengthen fears about a future break-up of the euro.² The financial cost of such a collapse would be enormous for all eurozone countries, including Germany, which could easily see the gains resulting from painful economic reform wiped out by a massive appreciation of its currency, making its exports much more expensive, and incur huge losses for its banks that have loaned to the periphery. The political cost for Europe at home and abroad would be even more disastrous. As doubts grew in the spring over the eurozone's ability to weather the financial storm, influential voices around the world started singing a requiem for Europe's global ambitions. "Even before it began, Europe's moment as a major world

power in the 21st century looks to be over," wrote Richard N. Haass, president of the New York-based Council on Foreign Relations, in May.³ If a break-up of the eurozone were to become reality, Europe would face a debilitating loss of influence and respect.

Simply put, the euro crisis has become an existential threat to European foreign policy, affecting not just the eurozone 16 countries but the entire EU 27. During the decade since the creation of the euro, the challenge for EU foreign policy has been how to match economic power with a commensurate diplomatic voice. But at precisely the moment that the EU seems to have created, through the Lisbon Treaty, an instrument that could enable it to coordinate its foreign policy more effectively, it faces a new setback as its economic prestige dwindles as a consequence of the crisis. If the EU finds itself unable to secure the long-term future of the euro, it faces irrelevance on the global stage – regardless of how it manages its foreign policy.

This brief – which is based on a series of interviews with members of the European Council on Foreign Relations who have either helped govern the eurozone as politicians or shaped the policy debate as economists – aims to explore the euro crisis in the context of this existential threat to European foreign policy. It looks at the economic and political origins of the crisis and examines a range of possible solutions to the problem. It argues that the new model of eurozone governance currently envisaged by the EU, based once more on the Maastricht Treaty, will be vulnerable to failure for the same reasons as its predecessors were. It recommends that Europe should finally build a monetary and economic system strong enough to last if it wants to remain a serious player and help shape the 21st century. For this, Europeans need to go beyond Maastricht and negotiate a new economic and political deal with the least pliant and strongest eurozone power, Germany.

¹ Declaration of 9 May 1950, available at http://europa.eu/abc/symbols/9-may/decl_en.htm.

² See, for example, Gideon Rachman, "How Germany could come to kill the euro", *Financial Times*, 22 November 2010.

³ Richard N. Haass, "Goodbye to Europe as a high-ranking power", *Financial Times*, 12 May 2010.

The origins of the crisis

The sovereign debt crisis that erupted in the eurozone in the spring of 2010 was a direct consequence of the rescue operation that EU governments had to conduct to save Europe's financial sector and economy after the collapse of Lehman Brothers in September 2008. "The first phase of the maneuver has been successfully accomplished – a collapse has been averted," said George Soros in June. "But the underlying causes have not been removed and they have surfaced again when the financial markets started questioning the credibility of sovereign debt. That is when the euro took center stage because of a structural weakness in its constitution."⁴ The unique character of the crisis arises from a number of overlapping failures. The first, shared across the West, is the catastrophic failure of legal control and regulatory oversight of the financial sector.

However, the global crisis has also exposed further failures that are specific to Europe. The crisis made apparent that the Maastricht-designed political architecture for the eurozone – with the deficit-focused Stability and Growth Pact as its *pièce de résistance* – was inadequate to cope with the real challenges that the single currency zone faced. In particular, it failed to prevent both the widening of disparities between the economies of its members and the huge cross-border bets that an increasingly interdependent, ineffectually supervised European banking sector placed on continuing growth and stability in countries across the eurozone. Ireland and Spain, each saddled with massive financial sector debt after a huge construction boom driven by speculation rather than demand, offer two spectacular illustrations, as they ranked among the best performers according to the Maastricht rulebook. "We have been talking about imbalances at least since 2005 but nothing was done," says Jean Pisani-Ferry.⁵ The lowering of interest rates in a number of eurozone members as a result of the creation of the single currency facilitated reckless spending and lending. "The creation of the eurozone has failed to enforce fiscal discipline," says Giuseppe Scognamiglio. "We underestimated the negative windfall effect of the euro," says Pascal Lamy.

As has now become apparent, the system built on the foundations of the Maastricht Treaty was also too weak to resist a severe financial market storm. "There was no crisis management provision in the treaty," says Pisani-Ferry. "There was this strange belief that crisis prevention through the stability pact would make crisis management unnecessary and even counterproductive, as it would create the wrong incentives." In the words of Wolfgang Münchau, "Germany, in particular, had reduced monetary union to its fiscal and monetary core, and thought it could achieve a stable and sustainable budgetary and economic situation through a

system of rules. Somewhat naively, it believed in the 'no bailout' rule for countries facing the threat of default. But, logically, if you have no bailout, no default and no provision for exiting the eurozone, by definition you have a fair-weather construction – and this was not even part of the debate or national consciousness, even among intelligent Germans."

Many of these systemic weaknesses in eurozone governance resulted from the long and often conflicting search for a way to deliver sufficient budgetary discipline and economic convergence while letting national governments and parliaments determine their own policies – leading to the Maastricht Treaty in 1991 and the Stability and Growth Pact signed in Dublin in 1996. At the time, a number of key policy actors privately expressed doubt that this rule-based model would last. "Everybody who follows this could predict that that would happen," says Jean-Luc Dehaene. "From the start, Jacques Delors warned that next to a central bank you need also a form of economic governance. But Germany always said this would compromise the autonomy of the (European Central) Bank."

The conflict continued even after the introduction of the euro. The years after 1999 saw numerous skirmishes between eurozone member states, who were keen to preserve their *de facto* sovereignty over national budgetary and economic policy decisions, and the enforcers of the Maastricht-based Stability and Growth Pact. The most telling and damaging clash was the successful Franco-German rebellion of 2003 and 2004 against a European Commission move to initiate sanctions procedures against Paris and Berlin for having failed to take action to bring their respective budget deficits back under the Maastricht limit of three percent of GDP. To many smaller member states, it seemed that the rules that had been enforced against them no longer operated when two big countries were targeted.

The subsequent decision in 2005 to introduce a number of modifications to the rulebook for economic governance – a move from 'Maastricht I' to 'Maastricht II' – was hailed by some at the time as a victory of common sense over bureaucratic rigidity. Today, it seems like a mistake. "The French and the Germans killed the Stability Pact in 2004," says Lamy. "This is one of the reasons for the Greek shock." Either way, the Maastricht model with its Stability and Growth Pact has now failed a second time under even more dramatic circumstances. With its focus on the public deficit, Maastricht II has been blind to systemically dangerous financial sector behaviour resulting from an abrupt lowering of interest rates as a result of the introduction of the euro, and it was too weak to avert destabilising economic imbalances within the eurozone. It prevented neither gross governmental accounting fraud in a country such as Greece nor problematic levels of national debt even before the rescue of the financial sector. It offered nothing to deal with the financial storm that grew out of these failures.

All of these deficiencies have now become key drivers of market forces as a result of the specific nature of the EU

⁴ George Soros, "The euro crisis could lead to the destruction of the European Union" (Humboldt University Lecture, Berlin, 23 June 2010), available at http://ecfr.eu/content/entry/commentary_the_euro_crisis_could_lead_to_the_destruction_of_the_europe/

⁵ Unless stated otherwise, quotes are taken from interviews carried out by the authors during 2010.

and the eurozone. A look at the economic data tells us that when it comes to overall public and private debt levels and current accounts, the eurozone is in better shape than the US. However, the markets have now made the eurozone, not America, the focus of their anxiety. The reason is simple. Whereas the US conforms to the recognisable and tested model of an established federal state complete with a large budget and flexible fiscal transfers from richer to poorer regions, the eurozone remains, in the eyes of many operators, an untested prototype apt to come crashing down to earth at any time. The markets automatically expect that the US will always do whatever it takes to ensure the cohesion and survival of the whole. The EU, on the other hand, has accumulated no such historical capital, nor does it follow a recognisable historic model. In the current crisis, it is paying a steep financial price for being *sui generis*. Tommaso Padoa-Schioppa says the markets attack the eurozone “because it is a post-Westphalian (post-nation-state) experiment, and people don’t believe in that.”

At the same time, the equivocation, angry exchanges and narrow national focus that eurozone leaders have displayed time and again since the outbreak of the sovereign debt crisis have further undermined the eurozone’s standing as a cohesive ensemble. Even worse, the failure to agree on a genuinely European plan for dealing with losses in the financial sector meant that individual member states had to take full liability for rescue operations that they could hardly afford. Ireland’s dramatic slide into a public-debt abyss is the direct consequence of this policy choice, forcing “Irish taxpayers to pay for bailouts undertaken for the benefit of bank bondholders in Germany, Britain [and] France,” as the economist Anatole Kaletsky wrote recently.⁶ Absent a joint European approach to restructuring the financial sector, other countries could suffer the same fate. Since the eurozone lacks a politically powerful figurehead able to enforce common decisions and speak for the whole with the authority of a strong office, divisions between member states have taken centre stage in the eyes of the markets, with disastrous effects on interest rate levels, public budgets and, ultimately, European citizens.

Maastricht III

The move to an agreement to establish a permanent European Stability Mechanism (ESM) to replace the EFSF in 2013 represents a fundamental and encouraging change in the approach of European leaders to the future of the eurozone. By anchoring it in the treaty, eurozone countries would be implicitly committing with the full weight of the EU’s highest source of law to do whatever it takes to preserve the stability and cohesion of the eurozone. Simply put, the ESM will provide for stronger cohesion of the eurozone at times of crisis. But it does not address the economic imbalances and the lack of plausible European leadership outlined above. The ESM can therefore be no more than the first of several steps towards restoring faith in the eurozone. “The crisis has brutally laid bare the weaknesses of the European model and of the euro,” says Joschka Fischer. “Either we seize the chance to move forward or the euro will break apart.”

The EU’s leaders have implicitly acknowledged this and called for a broad overhaul of eurozone governance to be completed by the summer of 2011. However, despite the resounding failure of Maastricht I and II, they have preemptively chosen to give the Maastricht-derived framework a third chance rather than seize the crisis as an opportunity to redesign their economic union in a more fundamental way. “The budgetary surveillance framework currently in place, defined in the Stability and Growth Pact, remains broadly valid,” wrote the Van Rompuy Task Force in its final report endorsed at the European Council meeting on 28 October.⁷ The precise shape of the reform will now be thrashed out in a process in which the European Parliament, its powers strengthened by the Lisbon Treaty, will play an essential role as co-legislator. Its key elements, as outlined in the European Commission’s proposals, indicate a future agreement to:

- step up coordination and mutual monitoring of economic and fiscal trends through the introduction of a so-called European semester
- require member states to set up a national framework to make budgetary planning more compatible with EU requirements
- target excessive national debt, as well as deficits, with a variation of the Stability and Growth Pact sanctions procedure
- toughen the procedure by making it easier and faster for finance ministers to adopt sanctions
- introduce new surveillance and possibly a new sanctions procedure to control imbalances in eurozone economies, based on a scoreboard of economic indicators

⁶ Anatole Kaletsky, “A New Idea to Save the Euro”, GaveKal, 2 December 2010, available at <http://gavekal.com/doc.cfm?src=forum&id=6400>.

⁷ “Strengthening Economic Governance in the EU – Report of the Task Force to the European Council”, 21 October 2001, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf.

There are deep disagreements between governments over crucial details of this third Maastricht system of eurozone governance, such as how to evaluate a country's imbalances or define excessive debt. However these disagreements are resolved, it already seems clear that 'Maastricht III' will share essential structural flaws with its two predecessors. In particular, it is not enough to construct a system of governance that looks efficient and coherent on paper but crumbles when exposed to the reality of politics in the 17 democracies (including Estonia) that will form the eurozone from January 2011. It is striking that, in the current reform debate, a number of plain, non-economic yet fundamental practical and political issues have gone almost unmentioned despite having made it structurally quite impossible to operate the Maastricht system successfully in the past.

There are at least three big problems with the Maastricht-derived rulebook that the ongoing reform does not seem to address. First, the Stability and Growth Pact ignores the way that in each country the political calendar and, in particular, the electoral cycle usually impacts the timing of economic and budgetary policy decisions as much as economic considerations. In other words, political timing and political context often trump economic timing. For instance, as John Bruton says, "the political reality is that you can only make serious expenditure cuts in economic hard times, because you can only get political consensus to make cuts in hard times. Making deep cuts in the middle of the boom may be theoretically the right thing to do, but it's politically impossible." There are no indications so far that the third attempt to get the Stability and Growth Pact right will acknowledge any of this, let alone create a framework that is able either to bend or to adapt to such a fundamental reality of politics in a democracy.

Second, EU member states' domestic rules and constitutional practices regarding the conduct of their economic and budgetary policy differ in fundamental respects. In some member states, it is mostly the finance minister who determines budgetary policy; in others, it is the head of government or the cabinet as a whole. In some member states, the parliamentary majority exercises a high degree of detailed control over the make-up of the budget; in others, the government will simply put the budget to a vote. In the past, the finance ministers assembled in the eurogroup – the eurozone's main steering committee – have often acted and spoken as if they possess the power to take decisions effectively binding all eurozone governments. But in reality they do not. They can woo, bully, cajole and, as their ultimate weapon, launch unwieldy sanctions procedures. But their collective power is very limited, no matter what the Maastricht rulebook suggests.

Third, it is inevitable that mistakes will be made. Over time, the European Commission, the European Council and the eurogroup, whose job under the Stability and Growth Pact is to guide member states and sanction the wayward, will inevitably give some erroneous guidance and sometimes base harsh sanctions on wrong economic assumptions. In

fact, Maastricht III will make this even more likely: with more options for sanctions built in, as a result of the ongoing reform, the odds increase that mistakes will occur. Inevitably, as time goes by, these successive errors will weaken the system's legitimacy and facilitate organised rebellion from unwilling recipients of guidance or punishment. The Franco-German uprising against Maastricht I was criticised by many as being "un-European". But both countries at the time defended their fiscal stance as appropriate; and, in purely economic and budgetary terms, later developments have tended to vindicate the German position. At the time, the German-inspired straitjacket of rules and punishment clashed with Berlin's own forward-thinking and strategic economic decisions. When it was applied to Germany as it had been to others, the Germans, with the French at their side, tore it apart.

The Maastricht framework as it is today, and as it looks set to emerge from the ongoing reform, takes little or no account of these three fundamental realities. It therefore requires a suspension of disbelief to assume that increasing the scope of sanctions and making them easier to adopt – the aims of the current reform – will make Maastricht III function where its two predecessors did not. "There is no way one can organise an effective European coordination without major changes in national practices and, in some cases, structures," says Hans Eichel. Making the Stability and Growth Pact work would, at a minimum, require a significant harmonisation of national habits of governance and, in some cases, even national constitutions to make them compatible with the European coordination and surveillance framework.

But, as Padoa-Schioppa points out, this throws up a paradox. "Many people say that a federal budgetary system is a dream of an EU that is a much stronger EU than they would like to see," he says. "But these same people see it as the EU's job to coordinate national budgetary policies, which is of course much more intrusive. There is no federation I know where the federal power coordinates the local powers. We are in the paradoxical situation that those who have little ambition to integrate the EU further have big ambitions about the role of the EU as a powerful, intrusive coordinator."

Alternatives

Faced with unabating market unrest and with the decision to establish a successor to the EFSF taken, some eurozone governments have now opened the debate about other means to strengthen the eurozone's cohesion and commonality.

Eurobonds

The most prominent and promising proposal concerns the gradual build-up of a massive Eurobond market equivalent to 40 percent of the GDP of the EU and each member state. In a spectacular development, it was endorsed – against well-known German opposition – by the president of the eurogroup and Luxembourg's prime minister, Jean-Claude Juncker, and the Italian finance minister Giulio Tremonti in the week leading up to the December 2010 meeting of the European Council.

German chancellor Angela Merkel immediately rejected the plan – followed, though in less categorical fashion, by French President Nicolas Sarkozy. Merkel's refusal to consider even a new discussion of the initiative followed a pattern often repeated throughout 2010, as the German chancellor, in the face of hostile public opinion, agreed to each step deepening eurozone solidarity only after fierce resistance and when no other course seemed sustainable in the face of mounting market unrest. Her flat rejection of the proposal is all the more notable as two senior figures from the opposition Social Democratic Party, Frank-Walter Steinmeier and Peer Steinbrück, called in an op-ed published the day before the summit in the *Financial Times* for “the limited introduction of European-wide bonds”, together with a haircut for debt holders, debt guarantees for stable countries and more aligned fiscal policies.

The advantages of a switch of much existing national debt to Eurobonds are numerous and obvious. The Eurobond market would rival the US Treasury market, creating favourable refinancing conditions for eurozone states and other participating EU countries. The depth of the market and its wide basis are the only reasons – along with a safe federal system – that US public debt remains as attractive as it does. A Eurobond backed by strong European institutions would give investors more clarity and predictability and send one of the strongest possible signals that eurozone countries are willing to bind their fates in the long term. The scope for speculation against individual countries would be significantly reduced and taxpayers would foot lower refinancing bills. Eurobonds – with their likely AAA rating – would facilitate much needed investment. Finally, limiting the Eurobonds to 40 percent of GDP would create a strong incentive for individual member states to bring down their debt as closely as possible to that ceiling, since further debt would have to be paid for with higher interest rates.

Notwithstanding Chancellor Merkel's argument against the legal feasibility of a switch to Eurobonds under existing

Eurozone enlargement

Remarkably, the sovereign debt crisis in the eurozone has not radically transformed the political dynamics affecting the further expansion of the eurozone. The accession of Estonia, which is due to join in January 2011, sped up when its inflation came down as a consequence of the crisis, allowing it to fulfil the formal accession criteria. Latvia and Lithuania, the other two Baltic countries, remain keen to join as soon as possible, with 2014 seen as the earliest realistic option. The European Commission holds the key to the Baltic enlargement process, as its assessment is the first hurdle that the two countries need to clear. Within the Commission and other European institutions is a debate about what consequences to draw from the crisis. While some push for a generous assessment of Latvia's and Lithuania's readiness to go under the umbrella of eurozone and ECB solidarity, others argue for slowing down the Baltic enlargement process, so as to avoid potential new sources of instability in the eurozone.

Throughout the crisis, Bulgaria's government has continued to say that it wanted to join the euro as soon as possible. However, it has yet to complete two years of ERM membership and the ECB seems currently inclined to delay Sofia's entry into the euro through a strict rather than generous evaluation of its readiness. The position of the Czech Republic, Hungary, Poland, Romania and Denmark (which is, of course, in a different legal, political and economic position) has shifted back to where it was before the crisis. The temptation to join the euro sooner rather than later, which prevailed as the global financial crisis unfolded, has receded in these countries as eurozone turmoil has grown. For Prague, Budapest, Warsaw and Bucharest, membership remains a treaty commitment and a stated political goal. But their accession dynamics are subject to the shifting patterns of each country's internal politics. In sum, the great eurozone crisis of 2010 has left the fundamentals of eurozone enlargement essentially unchanged – a testament to the strength and resilience of the great undercurrents of EU politics even at a moment of doubt and disarray.

European law, the Maastricht Treaty has never precluded a European debt vehicle, as the occasional past use of EU bonds shows: Eurobonds were issued to help out Italy in 1993 and to ease the transition in Georgia, Kosovo and Moldova before 2004. As recently as November 2008, Hungary was assisted with an bond issuance worth of €12 billion. The German government's opposition is mainly political in nature, prompted by the eurosceptic Constitutional Court and voters' fear of a small rise in their refinancing costs. But the further fate of the Eurobond proposal is likely to be driven by the need to counter further massive instability in European capital markets as much as by political considerations. At this stage, a commitment to build up a large Eurobond market would undoubtedly be the best available option to make clear to investors that the eurozone will fend off any attempt to undermine its solidarity. Even to Germans, the possible small price to pay in the guise of slightly higher refinancing costs might seem attractive if the alternative – the risk of the eurozone collapsing – is worse.

A Euro-TARP

The resistance against Eurobonds has prompted a search for other ways to stage a spectacular show of collective European resolve to stem the sovereign debt crisis. Based on the recognition that the need to bail out the financial sector is the single main cause of the sovereign debt crisis, one interesting proposal that has emerged is the creation of a European version of the Troubled Asset Relief Program (TARP) through which the US government bought assets from financial institutions.⁸ Europeanising the rescue of the banking system in this way would undoubtedly take a major burden off the hardest-hit eurozone members such as Ireland and Spain and go a long way towards allaying investor concerns about national sovereign debt. It would likely involve a contribution both from bank bondholders and bank shareholders, possibly going as far as a temporary public takeover of troubled financial establishments. But here the ECB's preference for a blanket bailout, grounded in its understandable fear of a new global credit freeze, clashes with member states' reluctance to let taxpayers bear the huge cost alone. In particular, the question is whether Germany, which came out against a single European rescue operation for the banking sector as soon as the financial crisis erupted in Europe, would now be more open to consider it.

An expanded budget

This year has demonstrated conclusively that the eurozone needs far more commonality in its budgetary, fiscal and economic framework to survive. In purely economic terms, one compelling option would be a gradual expansion of the EU budget to make it strong enough to act as an automatic

stabiliser for the eurozone economy and flexible enough to take over some redistributive functions within the EU. This would fit with the general trend of European politics. "The EU budget is very small compared with national budgets. As the EU seems to be required to achieve more and more, its budget should be seriously rethought," says Vaira Vike-Freiberga. The financing of defence policy, science and innovation, overseas aid, or even some social expenditure such as short-term unemployment assistance, are examples of spending which could be usefully and sensibly transferred from national to European level. Given the right policies and budgetary practices, the result would be more economic convergence, more political cohesion, better spending and healthier overall economies. Wolfgang Münchau suggests that moving from one to five percent of GDP – a very modest figure compared with typical national or federal budgets – might be sufficient to achieve the desired economic and political effect.

But however compelling the economic case may be, the political appetite among EU member states to devolve further budgetary power to the EU is currently close to nil. Because of this, Andrew Duff, who as an MEP has personal experience of the fierce resistance of member states, pleads for great realism and would see a 10-year expansion of the budget to an even more modest 2.5 percent of GDP as an "altogether startling growth of the federal budgetary power." Emma Bonino argues that this "federalism lite" would be the most sensible way to move forward. But even this slow expansion of the federal budget would likely come up against massive opposition, in particular from France, Germany and the UK. The EU's economic governance has reached an impasse: "People say they prefer close coordination and supervision, meaning an intergovernmental path rather than a federal one, but the truth is that there is no real appetite for that either," says Emma Bonino.

⁸ Anatole Kaletsky, "A New Idea to Save the Euro", GaveKal, 2 December 2010, available at <http://gavekal.com/doc.cfm?src=forum&id=6400>.

Conclusion

Europe's Economic and Monetary Union has been an extraordinary achievement. But the events of 2010 have made it apparent that its political governance was designed for fair weather. Having reluctantly taken the first step, European leaders must now make it storm-proof. Yet each promising move towards a better architecture is opposed above all by Germany, the eurozone's dominant power. Germany feels that its robust growth vindicates its own economic model, while its weaker partners feel more dependent on it. But Germany, *spiritus rector* of the Stability and Growth Pact, refuses to accept that its political model for a rules- and sanctions-based governance of the eurozone looks to have failed.

The most subtle defender of Germany's position, its finance minister Wolfgang Schäuble, gives a new twist to the German argument by pointing to the return of interest rate spreads within the eurozone as the best way to discipline eurozone member states in the future. But this makes bond investors the arbiters of economic and fiscal policy – even though these same investors have demonstrated time and again that their behaviour is herd-like and their collective judgment often dramatically unsound. Worse, it welcomes the return to a highly fraught European reality where national policy choices are relentlessly benchmarked by the markets against the narrow policy preferences of the most powerful country with the best track record – precisely the European reality that the euro was supposed to help overcome.

Europe now faces a choice between two versions of its future. It can continue to stumble through piecemeal reform, hope for the crisis to abate and, as Germany's finance minister suggests, leave it to the financial markets to impose fiscal discipline and austerity measures. But the limitations of this approach are evident. It entails a risk of permanent tensions, high financing costs for many, dim prospects for growth, and rising national resentment across the EU. It is a recipe for instability, oblivious both to the lessons of the past and to the promise of a better-organised future.

The second and better choice would entail a new grand bargain involving Germany. Berlin would first have to accept that, given their track record, betting on capital markets as permanent enforcers of sound policy choices is an unwise gamble in both political and economic terms, and one with poisonous potential for European politics. Berlin would also have to acknowledge that the third attempt to make the Stability and Growth Pact work might very well fail like its predecessors. But if Germany accepted these two realities, it would instantly acquire the power to write almost single-handedly an agreement to endow the eurozone with a panoply of instruments giving Europe the economic and political cohesion it desperately needs to succeed in a world of rising superpowers. Eurobonds, Euro-TARP, Eurobudget – the proposals are on the table.

In exchange for such a German initiative, many among Germany's eurozone partners, destabilised by their own sudden dramatic vulnerability, would be open to a profound adaptation of their economic model. Europe needs clearheaded, forward-looking German leadership that would anchor a European Germany in a more German Europe.

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