DOI: 10.1007/s10272-012-0428-5

Citizens' Europe: Crowded Out by Economic Focus

Over the last ten years the European unification project seemed to rely overwhelmingly on progress in economic terms. The most prominent achievements – the Single Market, the harmonisation of market regulation, the euro – were all driven by an economic rationale. However, attempts to rescue Europe from the ongoing financial crisis call for mutual support and solidarity, concepts that can hardly be derived from pure economic reasoning. This leads to an important question that has been too long neglected: what is the political and civic motivation for a united Europe? Besides a great desire to stabilise peace in Europe, the origins of the unification activities also included mutual interest in language, culture, habits and people in neighbouring countries. Has this been abandoned in favour of a purely economic vision? Or are the economic arguments merely the easiest to promote to the European population? What message does this send in times of mistrust in markets and dim economic prospects for the eurozone? Can a political, cultural and civic European spirit still be reinvigorated, and if so, how?

Heather Grabbe

Can the EU Take Its Democratic Values Seriously?

The European project has always had more than an economic rationale, but its democratic values agenda has always remained ambiguous. The European Union's public declarations and founding treaties contain many references to values and political principles, but in practice, its members and institutions have always struggled to define a detailed and specific set of standards of democracy that all its members would promise never to violate. Even more importantly, it has only the skeleton of an enforcement mechanism, which has never been used – in contrast with its panoply of tools to enforce market regulations.

Yet for countries that want to join it, the Union has developed a large set of implicit standards of democracy. Through its accession criteria, the EU demands that aspirant members achieve "the stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities", which is the political criterion set for achieving membership.

The process of meeting the conditions for membership had a major transformative effect on the twelve European countries that went through the EU accession process.[1] The twelve new members which joined the EU in 2004 and 2007 made great efforts to meet these conditions. Yet once they entered the Union, the new members felt the same as old ones: their leaders did not want the EU to gain the right to oversee on their internal political processes and domestic constitutional settlements. Over the past few years, the EU has expanded its mandate to promote certain values and democratic political systems abroad, but its members remain reluctant to give it a rationale of maintaining democratic standards within its own borders.

So does the EU really take its values seriously? A cynic might suggest that politicians always invoke values when they do not think that their economic agenda will be a sufficient emotional rationale for their project. As Jacques Delors, the Commission President who established the Single European Market, once remarked: "*On ne devient pas amoureux du Marché Unique*". For all the benefits that the EU's economic integration has delivered to its citizens, it never made their hearts swell with pride at being European. Nevertheless, values, and especially those associated with democracy, have always been an important part of the EU's *raison d'être*, and they became more so with enlargement.

For example, the EU is starting to take democracy more seriously in its foreign policy. Indeed, it was one of the newer members, Poland, that proposed the establishment of a European Endowment for Democracy during its first Presidency of the Union in 2011. This article explores the role of democratic values in the EU's evolution, both within its own borders and in its external policies.

1 H. Grabbe: The EU's Transformative Power: Europeanization through Conditionality in Central and Eastern Europe, Basingstoke, Hampshire 2006, Palgrave Macmillan.

The Slow Evolution of the EU's Democratic Values Agenda

In the first decades of the European project, its rationale was to move with small steps towards closer cooperation and integration. The European method was simple in principle, and it became radical in scale. The idea was to foster many small projects for cross-border cooperation, starting with economic ties in what were then the most fundamental industries of coal and steel. The rationale was that as politicians and officials worked together on these practical joint projects on running industry and developing markets, they would feel common cause, become familiar with one another, and overcome the suspicion and prejudice that was endemic in their societies. Over time, the logic of this approach turned into a drive towards economic cooperation for its own sake because of the additional benefits it brought.

But the rationale was always more than economic, and the values associated with democracy have always been a part of any declaration or founding document for European institutions. In practice, the European project is one of the most ambitious peace and reconciliation projects ever tried in human history – and one of the most successful for more than half a century. Democracy was an important distinguishing feature from the start. European integration was pursued by democracies and market economies that wanted to trade more with one another. Unlike with NATO, their cooperation was not conceived as an explicit alliance against communist Europe behind the Iron Curtain. But only democracies could apply for membership, and thus the organisation only accepted Greece, Portugal and Spain in the 1980s, after their transitions away from authoritarian rule. After the fall of the Berlin Wall, the goal of democracy promotion became a much bigger part of the European mission.

The EU's methods to foster democratic transition developed rather slowly, with political support for them growing incrementally. From the 1970s onwards, the EU developed a new agenda for supporting economic development and democratic transition almost by accident. It never set out to be a democracy promotion agency, but history created an enormous demand for the EU to become a major source of support for post-authoritarian transformation.

The Unexpected Mission: Supporting Post-Authoritarian Transitions

When Greece, Portugal and Spain emerged from military dictatorships, they soon applied for EU membership. At that time in the 1970s, there were no formal political criteria for membership, and questions of democracy were assumed to have been resolved domestically. The EU also had no standards for institutional competence and administrative capacity, which is perhaps why Greece was allowed to join in 1981 without much scrutiny of whether its state institutions could really implement EU policies and laws adequately.

After the fall of the Berlin Wall in 1989, the question of admitting the post-communist Central European countries brought the question of standards of democracy to the table of the European Council. By this time, there was a clear political consensus among the then twelve member states that political as well as economic and institutional criteria had to be set. Accordingly, the Copenhagen European Council established in 1993 that would-be members had to achieve "stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities"; furthermore, they had to be competitive market economies that could cope with the requirements of membership and adhere to the aims of economic, monetary and political union. These conditions led to the evolution of a large implicit values agenda, mainly developed by the European Commission, that has had a major impact on the political development of many European countries that went through the accession process for EU membership.

However, European standards of democracy remain more implicit that explicit. The EU's formulations are very general and vague, so it is difficult to apply these conditions in hard cases when countries refuse to comply. The EU has never defined in detail what it means by "rule of law" or what it regards as acceptable policies for protecting minority rights, for example. The Commission has often told individual applicants for membership to change particular policies or laws – the abolition of tor-

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ture in Turkish police stations, for example, or allowing Russian-speakers access to public-sector jobs in Estonia and Latvia. But the EU has no universally applicable guidelines on how to reach the standards of democracy that are required of its members, or how to maintain them. When applicant countries asked for more detailed guidance on meeting these conditions, the EU always struggled to provide a clear rationale: “We know undemocratic practices when we see them” was the usual response from officials; alternatively, they referred to a third party such as the Council of Europe or UN standards. They had no formal code of democracy to draw on.

The EU’s indirect approach seemed to work for Central Europe, which had some experience of democratic government prior to communism and remained culturally close to Western Europe. But it has been much harder to transfer democratic norms and practices to Albania and Serbia. These countries need much more help in putting down the roots of substantive democracy. And the recent constitutional crises in Hungary and Romania have shown that the transfer of democratic norms did not work as well in some of the Central European countries as previously thought.

Once they join, member states face no formal monitoring of the observance of these standards within their democratic systems, and there is no dispute settlement mechanism at the EU level when fights emerge between their democratic institutions, as happened this summer in Romania. The Lisbon Treaty sets outs some very general values in Article 2, and a procedure for review by the Council of any “persistent breach” of these values in Article 7. The Treaty also makes the Charter of Fundamental Rights legally binding, and courts are starting to use it. But none of these mechanisms has proved adequate to resolve power battles at the domestic level when governments try to change the rules of the game in their democratic institutions.

Problems of substantive democracy regarding the checks and balances between public institutions, and especially control of the media, have arisen in many member states in recent years, and the EU has not been able to play much of a role in resolving them. In addition to the problems in Hungary and Romania, a founding member of the Union, Italy, continues to be criticised for human rights violations of Roma and migrants.[2]

2 See, for example, the most recent report of the Council of Europe’s Human Rights Commissioner, Nils Muižnieks, available at https://wcd.coe.int/com.instranet.InstraServlet?command=com.instranet.CmdBlobGet&InstranetImage=2143096&SecMode=1&DocId=1926434&Usage=2.

The euro crisis has brought out a further set of institutional problems concerning governance. Greece’s economic problems revealed very serious problems with democratic control of state institutions and with the government’s capacity to manage key economic institutions. The EU gained a further oversight role as a result, when its members mandated the Commission to send a taskforce of its officials to assist the Greek government with improving the capacity of its institutions. It is not clear for how long this new function will last and how wide its remit might expand. National politicians generally dislike the intrusion of supra-national institutions in domestic governance, and the task force has been set up as an emergency measure rather than a permanent new competence of the Commission. But the crisis is far from over. Could the extent and depth of the institutional challenges revealed by the euro crisis create a new rationale for the EU in improving governance at the national level?

The Internal/External Democracy Conundrum

One of the many contradictions at the heart of the European Union today is that just at the moment when it is struggling with so many problems at home, it is embarking on a new project to promote democracy abroad.

For many years, the EU has put values clauses in its association agreements and other relationships with third countries. But it has a poor record of enforcing these conditions, having rarely used the suspension mechanism in its aid and co-operation agreements, despite flagrant breaches of its democracy and human rights clauses in countries like Algeria and Egypt over the past decades. Even where it has common policies on undemocratic regimes, these are frequently undermined by its member states offering special deals to favoured partners; for example, France granted a visa to Robert Mugabe of Zimbabwe while other members refused to do so. This failure to enforce the conditions has made the Union look weak and hypocritical.

This problem became very evident after the Arab revolutions of 2011. Many people in North Africa and the Middle East complained about the favourable treatment given by EU countries to the previous autocratic leaders and their families despite their undemocratic practices. This inconsistency – between the EU’s rhetoric on the importance of democratic values and its practice of doing deals with regimes that did not respect them – has badly damaged the EU’s credibility in the region.

Partly to remedy this problem and to strengthen its overall soft power in influencing the development of countries in transition, the EU decided this year to set up a new European Endowment for Democracy to fund democracy support outside its borders, especially in its neighbourhood of North Africa, the Middle East and Eastern Europe. This new institution could fill a hole in the EU's external values promotion toolbox. The EU has also just set up an External Action Service to combine its money and diplomacy, and the new Endowment is supposed to strengthen its role in democracy. Many details still need to be worked out regarding what exactly it will fund and what values it will promote.[3] Can the EU members reach a consensus on the democratic values that they want to promote externally while they remain ambivalent about what is acceptable within their own countries?

Why Is Europe so Squeamish About Democratic Values?

Europeans have a deep-seated ambivalence about democratisation, which makes them squeamish about promoting it outside the borders of their own individual nation-states. They have a common view of the basics of democracy that they mostly share with North Americans, but which are very different from the attitudes of Russians and many people in the Middle East. In terms of the institutions and practices that give substance to democracy, the European continent displays a wide variety of political systems. EU countries have vastly different methods of treating minority rights; for example, the French state grants its citizens rights only as individuals, not as members of an ethnic community, while the Greek constitution does not recognise the existence of minority groups. Members have very different approaches to the protection of civil and human rights, too.

When Americans talk about democracy, they usually have a fairly consistent idea of what they are talking about. The founding principles were laid down in the late 18th century in documents that every educated American knows about and many can recite: the Declaration of Independence, the Constitution and the Bill of Rights. Europe lacks such a solid consensus – and the Lisbon Treaty and Charter of Fundamental Rights were never intended to lay out the fundamentals of democratic institutions and government.

Most European countries moved towards democracy in fits and starts, interrupted by periods of dictatorship, wars and ethnic conflict. Consequently, Europeans tend to be more sceptical that democracy is the natural outcome of the evolution of societies. The legacy of fascism still haunts all of Europe, not just Germany and Italy – Europeans know how easily democratic systems can be undermined. Moreover, democracy is still a recent development in many parts of Europe. Greece, Portugal and Spain suffered dictatorship even into the 1970s, while Central and Eastern Europe achieved democracy only in the 1990s.

This variety of histories is an important reason why member states have given the EU very little role in monitoring the quality of democratic governance within individual countries. Europeans like their diversity of cultures and traditions to be respected – indeed, "unity in diversity" is one of the EU's mottos. This approach served it well during the Cold War. But three problems are now clear: first, it makes the EU very weak in using its "soft power" abroad. Second, it undermines attempts to found a European identity on an agreed set of values, making it hard for the EU to maintain a sense of common purpose as it has been expanding and becoming more diverse. And third, the squeamishness of European leaders about democracy continues to prevent the EU from taking action when democratic principles are violated in one of its own member states.

Steps Towards a Democratic Values Rationale for the Union

If it is to become more credible as a promoter of democracy abroad and a better guarantor of democratic values at home, the EU needs to define "European values" much more clearly. At the moment, it has a general reference in Article 2 of the Lisbon Treaty: "The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail." How exactly should these principles be codified, and how should respect for them be enforced? The EU's values rationale would be much stronger if it could spell out what constitutes common denominators such as the independence of the judiciary and media pluralism and the domestic institutions needed to enforce human rights.

The EU also needs to define its values for the benefit of its own citizens. Increasingly, politicians claim that the identity binding together European countries is based on common values. But these values are very fuzzy, so they cannot really be an emotional glue to hold Europeans together. And when member states fail to apply key

3 See J. Hale: How Could a European Endowment for Democracy Add Value?, 2011, http://www.soros.org/sites/default/files/eed-paper-20110927.pdf.

principles, the Union as a whole loses credibility among its citizens as a body that defends democracy. The EU needs to apply its supposed values consistently – both inside its borders and outside. The EU's criticism of how neighbouring governments suppress dissenting journalists will continue to have little impact if the media in Hungary and Italy are not fully free and pluralistic.

Finally, the EU needs to have more power to intervene if one of its member states fails to live up to its values. In theory, the EU now has some sanctions it could apply to wayward member states, but it finds them hard to use in practice. With the risk of backsliding by new members in mind, the EU's leaders created a new mechanism in 1997 that would allow the heads of state or government to suspend a country's voting rights in the Council of Ministers if it breached democratic principles. It is a "yellow card", like the one used by referees to warn football players that their behaviour is against the rules.

When the first test case came up in Austria, the other members decided not to use this procedure, because it was not clear how exactly to determine when a country was misbehaving or the circumstances under which sanctions might be lifted again. When Jörg Haider's Freedom Party joined the governing coalition in 1999, the other member states turned a cold shoulder to Austria at EU meetings – but these diplomatic sanctions were applied bilaterally by the individual member states, not acting together as the EU. The formal procedure was never employed.

The yellow card was further developed in the Lisbon Treaty, which came into force in 2010. Article 7 states that if there is a "serious and persistent breach by a Member State of the values referred to in Article 2", then the Council (comprised of the other members) may vote by qualified majority to suspend the offending country's voting rights and potentially suspend other rights (although these are unspecified).

While the yellow card is still an untested mechanism, the EU needs to specify in more detail what would constitute a serious breach of the democratic principles mentioned in its treaties. Otherwise it would be all too easy for a member state to claim that its behaviour was not really so bad, as Hungary's Fidesz government has done.

The Union also needs to develop a "red card" procedure that would allow the eventual expulsion from the Union of a member state which continued to violate core democratic principles and refused to take remedial action. Such an ejector seat would probably never be used, but its existence would make politicians with authoritarian tendencies back down.

Europeans need to get serious about democracy by codifying a more detailed set of European values and clearly setting out the institutions and practices that ensure they are respected. Such a document would help to ensure that EU membership fosters better governance, and it would also enhance the Union's credibility and influence abroad.

Henning Meyer

Analysing the Eurozone Predicament – Not One Crisis but Three*

The eurozone crisis is becoming ever more complex, and navigating through the maze is becoming more and more difficult. If experts fundamentally disagree on the origins of and solutions to the predicament and politicians are seemingly unable to grasp all the implications of their decisions, how can citizens be expected to make informed choices when casting their votes in elections fought over European issues or in referenda on the future of the Economic and Monetary Union (EMU)? In such a context, developing a clear structure through which to examine the crisis is crucially important, especially given that there are so many entrenched misperceptions lingering in key countries. The *Financial Times'* Wolfgang Münchau, one of the most astute commentators on the eurozone crisis, rightly argued that public opinion in Germany is both crucially important to resolve the crisis and unfortunately based on false facts:

> The problem is a shift in public opinion. The German public has bought into the narrative that the crisis was caused by profligate southern European politicians and consumers, who had wasted the first decade of their membership of the eurozone indulging in a debt-financed housing and consumption boom. It is a false morality tale – mostly devoid of economic reasoning. But this has not stopped it from becoming the dominant narrative. Not enough politicians, certainly not enough journalists and commentators, are pushing

* This article is an updated and extended version of the online essay "Can the Eurozone be Saved" published by Social Europe Journal (http://www.social-europe.eu/2012/07/can-the-eurozone-be-saved/).

against this narrative. Ms Merkel's single biggest error in her management of the crisis was her failure to get this narrative under control, or establish a narrative of her own. With her famous red lines on eurozone bonds and deposit insurance, she even ended up reinforcing the narrative.[1]

At the core of the predicament is not one eurozone crisis but three overlapping crises. This broad analysis of overlapping structural, political and democratic crises, first put forward in a column for the *Guardian* newspaper in early 2012,[2] seems to be a useful prism through which to analyse the situation. The different crisis strands are coming together to form a toxic mix, but for analytical clarity and in order to develop adequate solutions, it is important to disentangle them. The main purpose of this article is to develop an understanding of the three overlapping crises and to suggest some broad policy directions that could help to address them.

The Structural Crisis

The structural crisis the eurozone faces is a mixture of the design flaws of the eurozone itself as well as the construction and functioning of the financial sector. The eurozone design flaws[3] – such as the insufficient economic governance and macroeconomic surveillance mechanisms,[4] the limited constitutional role of the European Central Bank (ECB) as well as the problems stemming from the division of supranational monetary policy and national fiscal policies – mean that one country after another can be picked out and driven into financial crisis. There are also various channels through which contagion can spread across the EMU. This results in self-fulfilling prophecies of (near) insolvency across the currency union, even when the underlying economic fundamentals of specific countries remain sound. These issues have been extensively discussed in mainstream and academic media and are reasonably well understood.

Another structural issue is the deep competitiveness problems in some crisis countries. These are the result of massive intra-eurozone capital flows that should not have occurred in the first place.[5] There was a failure of macroeconomic oversight and regulation to prevent these capital flows, and banks had incentives to abuse their well-known too-big-to-fail status and engage in risky activities. The build-up and bursting of economic bubbles and the precarious positions some eurozone banks find themselves in are basically the result of this situation.

These structural flaws of the eurozone and their consequences converged with another structural source of economic distress: the financial sector-induced global economic meltdown set off in the United States and its continued impact on global economic development. Governments initially propped up their economies through stimulus spending and stabilised their financial sectors with unprecedented bank bailouts.[6] But this expansionary policy gave way to austerity policies in many countries, the result of which has been either sluggish growth or outright recession. Even half a decade after the outbreak of the global financial crisis, neither the too-big-to-fail issue nor other structural problems have been resolved. This is disturbing because, in many important ways, the structure and incentive systems of the financial sector are in urgent need of reform, as the sector still presents a source of economic instability and the potential for unleashing another crisis.

Do We Witness Sovereign Debt Crises?

Related to these structural aspects are sovereign debt issues. Current sovereign debt levels are composed of three elements: First, the pre-existing debt levels before the crisis, which in most countries were unproblematic. Second, new debt accumulated as a result of necessary economic stabilisation measures in the first crisis phase after the London G20 and the loss of tax revenues combined with higher social costs as economic activity deteriorated. Third, the rather widespread socialisation of private risks and debts. To illustrate this composition of national debt, the example of Ireland is very instructive.

For more than a decade, debt-to-GDP ratios in Ireland were on a downward trajectory (see Figure 1). As recently as 2008, they had been reduced to 25% – much lower than in Germany, for example. The massive increase

1 W. Münchau: Weidmann is winning the debate on policy, in: Financial Times, 2012, http://www.ft.com/cms/s/0/130ad186-f82c-11e1-bec8-00144feabdc0.html#axzz264a0j32d.

2 H. Meyer: Three steps to a strong eurozone, in: The Guardian, 2012, http://www.guardian.co.uk/commentisfree/2012/feb/21/three-steps-to-strong-eurozone.

3 H. Meyer: The eurozone's critical design flaws, in: The Guardian, 2010, http://eprints.lse.ac.uk/38566/1/The_eurozone's_critical_design_flaws_(LSERO).pdf [Accessed 23 August 2012].

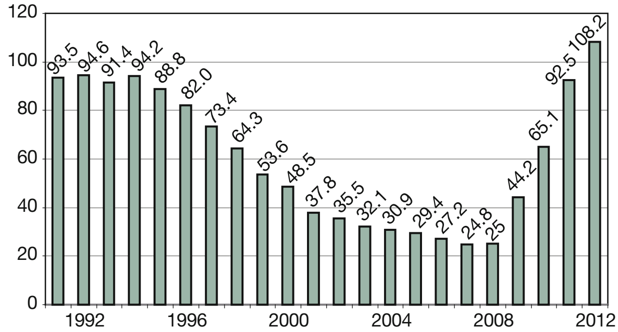
4 T. Knedlik, G. Von Schweinitz: Macroeconomic Imbalances as Indicators for Debt Crises in Europe*, in: JCMS: Journal of Common Market Studies, Vol. 50, 2012, No. 5, pp.726-745, http://doi.wiley.com/10.1111/j.1468-5965.2012.02264.x [Accessed 5 September 2012].

5 P. Krugman: ECB Death Wish, in: The New York Times, 2012, http://krugman.blogs.nytimes.com/2012/07/05/ecb-death-wish/ [Accessed 10 September 2012].

6 S. Khatiwada: Stimulus Packages to Counter Global Economic Crisis: A review International Institute for Labour Studies, Geneva 2009.

ZBW – Leibniz Information Centre for Economics

Figure 1
Ireland's Government Debt to GDP
in % of GDP



Source: www.tradingeconomics.com; Eurostat.

in government debt since 2008 is due to the latter two elements described above: the breakdown of Ireland's growth model in the wake of the global economic crisis and the economic effects of this, as well as the wide-ranging socialisation of private debt. As Martin Wolf of the *Financial Times* observed, the real macroeconomic risk in the case of Ireland was the indebtedness of the private, not the public, sector. The rushed socialisation of this debt shifted the burden onto the government. In 2008, Irish private debt was almost ten times as high as public debt:

> The ratio of private credit to GDP jumped from around 100 per cent in 2000 to 230 per cent in 2008. Foreign lenders played a huge role in funding this boom: the net foreign liabilities of domestic banks went from 20 per cent of GDP in 2003 to over 70 per cent in early 2008. The global financial crisis caused an immediate cessation in the capital inflows. In panic-stricken response, the Irish government guaranteed bank debt in September 2008. As the fiscal costs mounted, driven by the slump and the need to rescue the banks, what began as a financial crisis ended up as a crisis in public debt. It is not the first time an out-of-control financial sector has ruined the state. It will not be the last.[7]

Even though the picture across the crisis countries is not uniform – one can certainly argue that the situation in Greece developed differently – the Irish example fundamentally disproves the widespread assumption that irresponsible government spending was the root cause of the fiscal crisis. The fiscal problems were the result of the structural problems explained above. And the fact that financial players are currently exploiting eurozone weaknesses by putting excessive pressure on countries caught in debt traps – with no regard to their own crucial role in driving them into this situation – is another indication that deep structural reform and proper regulation of the sector is long overdue.

The Political Crisis

The political crisis has made the overall situation worse still. We still do not have a full blueprint for a sustainable eurozone architecture, only individual measures that do not seem to add up to a coherent strategy. Furthermore, political leaders have failed to stabilise the crisis. They have been *reacting* to events rather than *shaping* them. In recent weeks, there have been more hopeful signs from both key eurozone governments and the ECB, but even if political leaders now find the resolve to tackle the root causes of the problems, they will find it very hard, as years of "muddling through" have done major harm to the political foundations of the European Union in general and to the eurozone in particular. The political crisis is to a large extent driven by the mistaken (see above) analysis that the sovereign debt problems were the *cause* of the crisis rather than the *result* of deeper structural issues.

The result of this misunderstanding was a policy shift away from expansionary measures and towards austerity. The self-defeating policy of austerity has not only pushed crisis countries into recession and failed in its primary aim of reducing debt-to-GDP ratios but has also driven European nations apart politically and thus fundamentally weakened political cohesion in the eurozone.

It is true that the economic bubbles in the South should not be re-inflated and that the restoration of competitiveness also means pursuing a difficult process of adjustment. But this adjustment process needs to be shared across the eurozone, i.e. it needs to be symmetrical, including higher wages and higher inflation in the core countries. An asymmetric adjustment achieved solely through deflation in the South is economically and politically unviable.[8] It is often argued that pushing up wages in the core would make the eurozone uncompetitive vis-à-vis the rest of the world. However, this tendency could be addressed by devaluing the euro, which would ensure that external competitiveness would not suffer along the way.

7 M. Wolf: Ireland needs help with its debt, in: Financial Times 2011, http://www.ft.com/cms/s/0/436234b8-3ebb-11e0-834e-00144feabdc0.html#axzz264a0j32d.

8 P. Krugman: Why is Deflation Bad?, in: The New York Times, 2010, http://krugman.blogs.nytimes.com/2010/08/02/why-is-deflation-bad/.

It is argued that a shock adjustment is the way to go, but such an approach is neither politically viable nor socially acceptable. It is also incompatible with a symmetric approach, as there would not be high enough wage increases in places like Germany overnight. The levers of conditional credit can force reform measures in crisis countries. Comparable levers for upward adjustment in the core countries, however, are missing. It is therefore extremely important to set a credible path for symmetric adjustment.

The Crisis of Democracy

The democratic crisis across the eurozone is worsening dramatically and might well be the fighting ground that eventually decides its fate. In both eurozone countries that are providing help as well as those that are receiving it, there is a sense of powerlessness and exclusion when it comes to decisions taken in the wake of the eurozone predicament, especially when many of these decisions appear to be making the situation worse (see above). Amartya Sen also highlighted the link between the failed policies and the way they were pursued when he wrote in the *Guardian*:

> The problems we are seeing in Europe today are mainly the result of policy mistakes: punishments for bad sequencing (currency unity first, political unity later); for bad economic reasoning (including ignoring Keynesian economic lessons as well as neglecting the importance of public services to European people); for authoritarian decision-making; and for persistent intellectual confusion between reform and austerity. Nothing in Europe is as important today as a clear-headed recognition of what has gone so badly wrong in implementing the grand vision of a united Europe.[9]

Some of the democratic problems stem from the euro's structural design flaws. The fact that 17 sovereign fiscal decision-making procedures operating within a single currency union would create policy externalities for all euro countries was not adequately understood. If this had been understood more thoroughly, the inappropriateness of the Stability and Growth Pact (SGP) and the lack of more exhaustive macroeconomic oversight mechanisms would have been obvious.

There are also national democratic crises, as the burdens of economic adjustment are currently not only unevenly distributed *amongst* countries – deflationary adjustments in the periphery countries, but no corresponding structural adjustments in the core countries – but also *within* countries, partially because of credit conditionality and partially because of deep-seated democratic problems in some member states. Across the eurozone, people increasingly seem to be losing faith in politics and the ability of the political class to master the huge problems while maintaining democratic principles.

Furthermore, the move towards a political union, necessary to overcome the euro's structural flaws in the long run, faces several serious challenges. It is often argued that a mutualisation of debt would create a moral hazard, as it reduces the pressure on debt-burdened countries to pursue necessary adjustments, and it breaks the link between decision and responsibility – analogous to the same broken link in the financial sector. There are basically two options to address this issue. In the first scenario, which does not involve a full political union, 17 national decision-making procedures are kept in place, and constraints are placed upon them via generally binding rules. This is currently being pursued through the European Fiscal Compact, which is meant to enshrine debt brakes into national constitutions.

Even if there were a way to establish permanent fiscal rules that were "right" – and in this author's view, the European Fiscal Compact rules are not right – the big issue of enforcement would need to be addressed. Under current plans, the European Court of Justice will police the fiscal rules and could fine a country in breach of them up to 0.1% of GDP. But is it realistic and sensible that countries already in financial difficulties could be fined for breaking fiscal rules? What happens if they will not or cannot pay? This approach is a tougher variant of the SGP system. It has not worked in the past, and it is unlikely to work in the future for the same reasons. Seen in this light, the common rules approach – even if there were a way to establish the right rules – seems unworkable.

There is a potential moral hazard issue, but it has to be contained by a governance mechanism with teeth that intervenes before a spending decision is finalised (*ex ante*, not *ex post*). This would mean supranationalising a large part of fiscal policy decisionmaking, which effectively breaches current national sovereignty rules and would be unconstitutional in most, if not all, eurozone countries. So this kind of political union would require extensive constitutional change at the European and national levels.

At this point the scale of the task becomes clear: there are no easy solutions and no quick fixes. Is such a su-

9 A. Sen: Austerity is undermining Europe's Grand Vision, in: The Guardian, 2012, http://www.guardian.co.uk/commentisfree/2012/jul/03/austerity-europe-grand-vision-unity.

pranationalisation possible? Would citizens across the eurozone back such a move, potentially even by referenda? If these hurdles cannot be overcome, could minimal integration, for instance a banking union, be implemented without full fiscal integration? Could such a construction work, or would the euro still inevitably fail at some point, with all the huge and unpredictable political, economic and social consequences that entails? Can such a large reform be achieved in the short term, effectively with a gun to the head? Or if not, could we at least set a process in motion that would transform the eurozone in this way, perhaps over the next decade or so? These are crucial questions that need answers.

The recent decision by the ECB to purchase unlimited short-term bonds in the secondary market to stabilise sovereign debt yields of crisis countries was welcome in monetary policy terms, as it signalled a move away from its restrained role, as indicated above. In democratic terms, however, it was a very problematic move, as ECB action under the Outright Monetary Transactions scheme requires a crisis country to be part of a European Stability Mechanism programme. These programmes set harsh policy conditionalities and in effect are very likely to entrench the failed austerity approach even further. As the Oxford economist Paul Collier argued, it could be that a monetary intervention by the ECB will be dependent on how the Washington-based International Monetary Fund (IMF) judges programme compliance:

> While the ECB will provide the funds that underpin continued membership of the Euro by Southern Europe, the ECB itself will not set the conditions by which its money will be released. That role is reserved for the European Commission in collaboration with the IMF. Since the Commission has neither the political authority nor the technical prestige to take the lead in setting these conditions, in practice they will be set by the IMF. As long as the IMF remains satisfied, the ECB will underwrite sovereign debt, and the continued membership of Southern Europe in the Euro will be guaranteed, unless its leaders decide, of their own volition, to withdraw. Since no politician will be willing to incur the abrupt costs of personal responsibility for withdrawal, the prospect appears to be that Southern Europe will be subjected to a standard IMF Program, minus the exchange rate adjustment that the IMF normally requires.[10]

10 P. Collier: What does the new ECB Commitment to the Euro imply?, in: Social Europe Journal, 2012, http://www.social-europe.eu/2012/09/what-does-the-new-ecb-commitment-to-the-euro-imply/.

As a result of this, the institutional architecture of the eurozone is becoming more and more muddled and less democratic, pointing again to the need to fundamentally redesign the eurozone's institutional setup. A situation in which an unelected and largely unaccountable central bank, in cooperation with other institutions with very weak democratic credentials, effectively sets the framework for national fiscal policy cannot be sustained for the long run and is in fundamental conflict with the endeavour to democratise the eurozone and the European Union as a whole.

Where Do We Go from Here?

What needs to be done? There are of course so many necessary steps to be taken that it is impossible to list them all here. But based on the analytical structure set out above, the author would like to put forward some key points.

First, growth is necessary to make structural adjustments and the medium-term reduction of debt-to-GDP ratios possible. This requires a move away from austerity and the decoupling – as much as possible – of competitive adjustment from fiscal policy. Competitive adjustment primarily needs to take place in the private sector, and governments should support this difficult process with growth-enhancing measures, not austerity. This of course requires a fundamental shift in the crisis policy that has been pursued hitherto. This kind of policy change would not just create a real chance for the necessary adjustments to take place but would also stop the disintegration process that is already underway as a result of the crisis and the policy reaction to it. The ongoing erosion of the basis of European integration must be stopped urgently.

Second, new growth could not only help to address competitive imbalances but also the huge unemployment issues if stagnant or slowly increasing real wage levels in the South were matched by considerably higher wage increases and higher inflation in the core, i.e. a symmetrical adjustment. This in turn could also help to bring social costs and public deficits under control as well as get more citizens to support the difficult path of adjustment and reform.

Third, the increasing levels of inequality have been identified as one of the key structural drivers behind our broken model of finance-driven capitalism. Inequality is revealed, for instance, by the ever-decreasing income share of wages in the face of an ever-increasing share of profits. Addressing this issue is an urgent matter for the reform of the economic system as a whole. It is also essential for ensuring the fairness of the adjustment process as well as for regaining trust in democracy and democratic control over the economy. In the medium to long term, it is also a requirement for a more sustainable growth model based less on personal debt.

Fourth, it goes without saying that, given the arguments above, the fundamental reform of the financial sector remains another key political priority. Major reform proposals, such as the division of retail and investment banking and the elimination of the too-big-to-fail problem, have been on the table for some time. The political challenge will be to find ways to implement such proposals as widely as possible.

And fifth, there needs to be fundamental institutional reform of the European Union and the eurozone at its core. Multi-speed European integration has been a reality for some time, but it is now important to formalise this in a new permeable institutional structure that allows countries to move to the integration level where they feel comfortable. The development of a concentric circles model of European integration must also abandon the Europe à la carte approach, where each country can effectively negotiate opt-outs from certain aspects of the Union. In an EU of 27 and even more members in the future, such an approach is simply too difficult to govern.

Apart from creating clear qualitative levels of European integration, the eurozone at the heart of the Union needs to be fundamentally democratised. Not only does the clear distinction between monetary and fiscal policy need to be restored, the further political integration of the eurozone also needs a stronger democratic foundation. Analogous to the Eurogroup in the Council of the European Union, there should be a Eurogroup in the European Parliament, consisting of MEPs from eurozone countries, that can take decisions on matters only affecting the currency zone.

Conclusion

The fusion of the structural, political and democratic crises is becoming more and more complex, but disentangling the different crises helps us to analyse the situation more thoroughly. Against this backdrop, it looks increasingly likely that the issue of democracy will ultimately decide the fate of the eurozone in one way or the other. The European integration process driven by elites seems to have reached its limits. In the long run, the eurozone crisis can only be solved through a democratically legitimised leap forward; the alternative is disintegration, which could be a political, economic and social disaster. At its core, the eurozone crisis is a political crisis.

As the author suggested in a *New York Times* debate in 2011,[11] the ultimate test for any approach to solve the eurozone predicament will not only be whether it can resolve the structural and political issues involved. Ultimately, a crucial test is also whether citizens throughout the eurozone can be convinced that the difficult process of adjustment and reform is a price worth paying and that a more prosperous future, in which they have a political as well as economic stake, lies ahead of them.

11 H. Meyer: Primarily a Political Crisis, The New York Times, 2011, http://www.nytimes.com/roomfordebate/2011/08/11/why-arent-germans-protesting-over-european-debt/the-eurozone-crisis-is-a-political-crisis.

Diego Valiante

Building a Political Euro Area and a “Federation of Regions”

Government crises and early elections scattered across the euro area have reopened (if they were ever really closed) the discussions about political instability in the eurozone. In the last year, changes of government in France, the Netherlands, Slovakia, Italy, Greece, Slovenia, Belgium, Portugal and Spain, whether through elections or internal political crises, and the upsurge of extremist parties have exacerbated an already fragile economic and financial situation. In combination with these events, highly volatile trends in financial markets remind us of the strong interconnection between political and economic instability.

A Well-known Disease

The causes of economic instability in the eurozone are more or less known, even by the general public. The global crisis has led to drastically reduced growth and internal demand, bringing to light important competitiveness gaps among member states in attracting new investments to compensate for dropping internal demand and capital inflows from other EU member states, which has resulted in asset bubbles in different sectors. Low fiscal revenues, capital flight and the inability to adjust exchange rates have put public finances under severe strain. As a result, adjustments can only be delivered through direct or indirect transfers (joint liabilities on common bond issuances, for instance) from countries with current account surpluses and by simultaneously promoting real adjustments in deficit countries, such as labour market and pension scheme reforms.

Disagreement on how to face this well-known disease has increased political instability, and diffused national turmoil and changes of government now seem unstoppable, especially if the political bloc opposed to austerity measures continues to strengthen across the euro area. The link between economic problems and political instability is clear-cut, but more attention should be paid to how political instability (e.g. due to the inability to design a common exit strategy) aggravates and prolongs economic problems.

Political and Institutional Disarray

In the history of modern economies, the eurozone, which was formally completed with the monetary union in 1999, is perhaps a unique case of economic and financial integration. Despite fundamental changes that have increased the powers of European institutions and shrunk the boundaries of national sovereignty, the political and institutional set-up that governs an economically and financially integrated area has remained unchanged. In effect, a disintegrated group of member states, then, leads the efforts to handle its political governance.

In contrast to this fragmented political setting, economic and financial integration, via the single market and the monetary union respectively, have advanced and de facto created a semi-federal state, in which the transfers among member states are indirect (through the surplus countries' implicit guarantee of the debt issuance of deficit countries). With the sovereign crisis, these implicit guarantees have not fully materialised because of internal government decisions, but sovereignty over monetary and (most) fiscal policies has been necessarily and irreversibly transferred over time to the euro area and EU levels. In effect, economic/fiscal policies and economic integration are strictly related. For instance, political decisions to regulate financial services, to fund important infrastructures, to liberalise agricultural and energy distribution, and to deal with competition policy and market supervision have gradually passed on to a supranational level (formal competence at the EU level and budgetary control at the EMU level).

Beyond the exclusive and mutual competences, however, key decisions at the EU level are often major political compromises and the result of poor attempts to protect national interests. The current institutional set-up is clearly unable to build a long-term political project, and citizens' democratic control over key decisions is limited to the European Parliament, which does also elect the leadership of the European Commission but only after the candidates are nominated by national governments. The Parliament also interacts with the Council of the European Union in drafting new legislation, which is finalised through the legislative process and its opaque, informal "trialogue" (within the co-decision procedure), which makes lobbying activities very effective. Furthermore, very limited resources vis-à-vis the sheer volume of regulation proposed by the Commission since the crisis makes the European Parliament scarcely effective in shaping the underlying structure of new regulations. Moreover, the independence of the European Commission is regularly put under strain due to intrusions by national governments through Commissioners' cabinets and less regularly by MEPs. At the third corner of this triangle, the Council of the European Union has been designed to represent national governments and protect what they perceive as their national interests (with minimal control over these decisions by national parliaments).

As a result, this institutional architecture is at the heart of the political instability in the euro area. Decisions that affect the whole monetary union, and in particular all matters having broad budgetary implications, need to be agreed upon among governments, with limited participation and democratic control by citizens. The limited attractiveness of major national parties and their inability to build a stable consensus lie in their difficulties in offering a long-term political project, because such a project cannot be materially pursued outside the perimeter set by the European bureaucracy.

The Inability to Take Long-term Decisions

As a result, this institutional set-up, which works just fine for a European Union generally seen as a free trade area with some common institutions, is – possibly deliberately – unable to take long-term political decisions (especially in time of crisis) for a euro area that, due to its high level of economic and financial integration, essentially resembles a federal state more than a sophisticated free trade area. The long-term effects of ceding monetary sovereignty (the core element of national sovereignty) to a common institution have clearly been underestimated by euro area members, especially the impact this has on democratic accountability.

This important shift, in effect, has left an empty space in the programme of national parties and politicians. It has transformed member states (and their debts) into regional areas whose authority over important competences, such as national security and health care, is subject to a budget that must (now formally) be approved in Brussels. National political establishments have lost important pieces of their political projects (which are now part of Europe-wide decisions), giving space to narrow-minded national political ideas championed by extremist parties. We now live with the paradox that the European Commission, led by technocrats, exercises strong influence on long-term political decisions and the single market; meanwhile, national political establishments have to deal with implementing rules (which often require technocrats' support) and explaining to citizens projects that were inspired by a supranational diplomatic setting among member states' governments.

What Comes Next?

The unstable economic and political situation compels Europe to take bolder actions, bearing in mind that building a new Europe might be harder than tearing it apart. Carrying out more technocratic work at lower institutional levels (i.e. state or regional levels) in compliance with EU-wide rules and eurozone-wide policies, while at the same time promoting greater democratic participation in this institutional framework, are difficult tasks that need a new European political class to emerge and fill the democratic gap. The alternative to an institutional consolidation is to let the centrifugal forces generated by an institutional set-up that was designed to protect national interests ultimately destroy the euro area (and most likely the single market, too).

The situation can degrade quickly. On the one side, the austerity axis consisting of Berlin, Paris and Rome is beginning to falter (led by Hollande's policy shift in Paris). On the other side, a return to national floating currencies seems undoubtedly impracticable and anachronistic vis-à-vis the gradual shift of the global economic pendulum towards emerging economies and the ensuing need to ensure long-term stability and global competitiveness in the region. As a consequence, the economic decisions to be taken are more or less straightforward (among others, liquidity firewalls and ultimately a gradual mutualisation of debts). However, the political instability due to the obsolete institutional framework condemns us to unceasing and thus more painful economic uncertainty.

The strong level of integration achieved over the years (particularly in the euro area) will not allow Europe (and, in particular, the eurozone) to further postpone a call for a more federal government to determine EU policies. It is the only mechanism capable of taking long-term decisions and preserving democratic control, thereby providing legitimacy to decisions that affect the lives of EU citizens.

The rule of law can typically survive in a state lacking democratic accountability. However, in European traditions and culture, democratic control and accountability certainly outweigh the sound economic justifications for stronger pan-European integration based on the rule of law in order to preserve competitiveness in a global economy. The system must enable citizens to hold those representing their interests accountable for their decisions. Lack of democratic control increases agency costs between decisionmakers (politicians or technocrats) and citizens, who find it difficult to put forward their demands. With more democratic control, citizens will be able to directly influence legislation and policies that have a major impact on their lives, which will make EU actions more congruent with citizens' demands and thus more efficient. A current major point of friction is the excessive political intermediation and disproportionate powers granted to institutional layers that do not respond directly to citizens, especially in a fully economically and financially integrated area like the eurozone.

A European Federation of Regions

A solid federal framework would connect citizens to the governance of their institutions. There are few doubts today about the need for Europe, and in particular the euro area, to move towards a more federal organisation among member states. However, it remains to be seen what kind of federal architecture Europe should opt for. Historically, the form of state is the conduit through which democratic governance can prosper as the final and unquestionable will of citizens. Institutions should adapt to the evolution of their own societies; this is also true for the governance of an integrated area such as the eurozone once the decision was made to centralise sovereignty on monetary policies.

There are two types of federal structures that could be considered at this stage. The first one is a "federation of states" in which exclusive and mutual competences between states and the central government in key policy areas are better clarified. In light of current political conditions, this seems to be the most likely outcome that the euro area (and perhaps the European Union) can hope for. However, in practice, it may prove to be an inadequate and only temporary solution, because strong central governments, as they are currently designed with heavy central control and cost structures, will have a hard time coping with a more pervasive European architecture. As a result, the attempt to control the manifold local centres of expenses by cutting expenditures and maintaining the central government will place more pressures on local authorities, thereby compressing further the financial autonomy (and powers) of the institutions closest to citizens.

In effect, this first model of federalism builds upon a strong process of centralisation at the main point of expenditure, i.e. the national government, in order to have direct control of the sources of expenses falling under it. The rise of protests in some key regions across Europe, such as Catalonia, suggests that the problem of meeting regional demands has been swept under the carpet but not solved by greater European integration. The institutional set-up in Europe has managed to muddle through so far because of the light institutional framework of the free trade area with well-defined competences, which has been able to simultaneously protect national interests and provide a period of stable growth, keeping economic divergences under control.

Europe must aspire to something more important and more permanent with its own institutional architecture, something able to control the process of merging a cosmopolitan and integrated area with enduring strong regional identities that build upon common traditions and cultures. Respecting the role of the nations in bringing together different identities under a common system of values enshrined in national constitutions, a federal Europe should look at the regions as the final outcome of a pan-European project. Regions are common ethnic, cultural, social, economic and political identities currently recognised in various manners (as provinces, autonomous regions or small states).

Despite the strong convergence in the last two decades towards a common European society as well as the technological developments that allow greater cross-regional interaction, regional differences remain a distinct element of traditional European values. The process of European integration should be regarded as irreversible, because large regional clusters of countries shape the world. However, policies cannot impose deeper cultural integration than people want. The project for a more integrated Europe, therefore, must not neglect the competition among regional areas but rather should build an institutional framework that allows this competition to deliver benefits for everyone.

A common European or eurozone federal project should incorporate this profound element of the society into policy and the law-making process. This could potentially lead to the creation of a second parliamentary chamber for regions to be directly represented at the European level. Based on the ideas they put forward, many politicians' thinking on European integration is limited to the transposition of a Northern European model of governance and policy to Southern Europe or to any countries which strive to emerge as competitive champions. This is misguided.

The federal European project will not be successful if it does not allow each region to pursue autonomous economic and social development under the common rule of law and through a legislative process able to interpret the aspirations of such an important but fragmented environment. A simple system of transfers and subsidies will only exacerbate the points of friction among these areas, although minimal mechanisms of support based on solidarity among regions must be part of the final idea of governance in order to give countries in trouble a chance to dig themselves out of the crisis (as mentioned previously, debt mutualisation is part of this process). In addition to the regions, the institutional architecture could perhaps give special recognition and competences to metropolitan areas. Regions will then act based on a principle of autonomy and subsidiarity, with more exclusive competences for them and less exclusive ones for central governments, while the European level would for the first time gain exclusive competence in common areas of integration, such as research and cross-border infrastructures.

Moving Forward

Whether the eurozone decides to go it alone towards a more integrated and federal government or to include all (or some) of the countries in the European Union, this fundamental step cannot come from a dusty table of prime ministers. The first step would entail an agreement with non-eurozone countries that do not want to proceed with this further process of institutional reform and political integration. For countries outside the federation, Memoranda of Understanding or a common Treaty could keep current common regulatory structures strictly or closely harmonised with national supervision, which would allow a clear definition of competences without hindering the importance of an integrated free trade area in the European Union.

The second step would entail a new European convention, open to everyone (e.g. intellectuals and experts), to discuss the best institutional framework for the entire continental region. Once two or three proposals were approved, citizens should be called to vote for these broad projects through a common and simultaneous

EU-wide referendum. Setting this roadmap for Europe today would be a courageous and far-sighted political decision; the role of leading guide for institutional reforms which are able to cope with fundamental societal changes would be given back to politics and thus democratic control. This process may find strong opposition from old political establishments that have political control over national governments, but early signs of political malcontent among citizens against the leaders of major national political parties is a clear indication of a crisis for the political groups that are not living up to their regions' demands.

Three potential scenarios could lie ahead of us. In the first, a "conservative scenario", Europe pushes for a federation of states but at the same time allows key areas of competence in policymaking to remain at the national level. The current institutional framework designed to protect national interests would also be maintained. The second "soft scenario" is the creation of a federation of states (maintaining regional competences in limited areas) with a different institutional set-up which aims for greater democratic control and may lead to the emergence of a common European political class. The final "innovative scenario" would require the completion of the aforementioned process, i.e. an EU-wide referendum and the thorough rethinking of the institutional architecture and competences to be shared primarily with member states, regions and metropolitan areas on the same level of recognition. This scenario would require a fair amount of time to be properly framed and for the development of a clear roadmap after the referendum has decided which model Europe (or the euro area) should follow.

It is in times of crisis that the political will to carry out fundamental changes to our institutions and our societies builds up. In the current scenario, a broader interest in a renewed idea of Europe may be awakened, one in which a common political class represents the different identities of our regions, integrated in an innovative and modern institutional framework. Economic policy tools that can avert the ongoing eurozone crisis may ultimately be insufficient to eradicate the political crisis lurking behind the financial and economic distress. Fiscal austerity measures and other sacrifices that citizens are undergoing to save the euro area should be the political precondition for a much broader and longer-term project for Europe to strengthen its political and civic rationales. If Europe does not begin work on this project now, its underlying political crisis (in tandem with its economic and financial problems) is due to continue and will increase social unrest rather than offer younger generations hope for the future.