



RESTORING THE UNION

Writing from Athens, a leading economist sees in the eurozone financial crisis the potential seed of a stronger union. But the cost may be more than financial.

Those among Europe's political and business elite who favor greater political and economic integration have had a rough few years. The global recession slowed output in nearly every European country. In many cases, recovery has been weak and faltering, due partly to Europe's greatest act of political and economic integration: the creation of the euro.

The eurozone's weaknesses have sat in plain sight from the start. The group of countries that constituted the eurozone did not meet the preconditions for a single currency to operate sustainably. Productivity and prosperity vary widely from country to country, and there are no financial transfers between them on a scale that would correct for those differences. And linguistic, cultural and economic barriers to migration hinder the labor mobility that would alleviate persistent unemployment.

The consequences have been felt most keenly in the country of my birth: Greece. In 2001, Greece was allowed to join the eurozone, ostensibly having met the economic preconditions. In reality, Greece had manipulated and falsified its economic data.

Entry into the eurozone gave Greece's consumers, businesses and government access to credit at much lower interest rates than they otherwise would have had. The risk of Greece's taking a haircut through devaluation disappeared, and the financial markets assumed that the eurozone would stand behind any of its member countries' debts.

The result was unsurprising: Greece went on a spending spree. In the meantime, it failed to press ahead with the difficult reforms that might have improved its productivity and competitiveness relative to other members of the eurozone, such as Germany. In fact, taking real unit labor costs as a measure of industrial competitiveness, the gap between Germany, the eurozone's largest economy, and the peripheral economies (those of Portugal, Ireland, Spain and Italy, as well as Greece) widened rather than narrowed.

This could not go on forever. In 2010 the markets decided that Greece's debt was unsustainable. The risk premium on government debt soared, and Greece faced insolvency. The International Monetary Fund,

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the European Central Bank and the European Commission financed a bailout. Greece now is implementing major fiscal consolidation and structural reforms, such as improving public sector efficiency, opening up the professions and liberalizing markets.

But austerity programs themselves reduce demand in the economy and slow economic growth. The latest forecasts for Greece are that 2012 will see the fourth consecutive year of falling gross domestic product, with a cumulative fall in output of some 12%. A second bailout package has been agreed to that will involve a significant element of debt forgiveness. Although the risk of Greece defaulting on its debts has been reduced somewhat, the markets still think there is a high chance of it happening within the next two years. Portugal and Ireland also have

been forced to take bailout packages because they could not finance their debts at sustainable rates.

A default by any one of these countries would deepen the financial crisis among banks in France, Germany and elsewhere that hold those countries' debt. Economic and political tensions are high. Certainly Greek politicians of all parties are responsible for the country's crisis. But the European Commission and the other member states are not blameless. They did not effectively scrutinize Greece's economic data. They watered down the Stability and Growth Pact, the eurozone's rulebook, when it became clear that France and Germany might fail the budget deficit test. And the technical assistance the EC provided Greece was inadequate given the scale of structural reform it needed.

Can the eurozone hold together? I believe its long-term viability will require stronger economic and fiscal governance, including:

- Limits — backed by the risk of sanctions — on member states' ability to run up budget deficits
- Greater consistency between the economic and social policies that underpin productivity and competitiveness in each country — including traditionally sovereign decisions such as retirement ages, pension financing and healthcare systems
- Much larger fiscal transfers between "rich" and "poor"



members of the eurozone, either through making direct transfers (such as the current Structural Funds but on a larger scale) or by allowing members to issue debt backed by the eurozone collectively

- Radical reform of the governance structure in Europe to cope with the emergence of a lender of last resort: the ECB, with enhanced powers and the European Financial Stability Facility, currently at €440 billion, but the intention is to expand it to €1 trillion
- Closer monitoring of individual governments' fiscal policies and greater involvement of the European Commission

These are controversial ideas that, if implemented, would profoundly strengthen political integration while affecting national sovereignty. Many policies that currently are the choice of member states and their electorates in effect would become collective choices determined in some way by eurozone members. But already, alongside the negotiation of bailout packages for troubled member states and an ongoing debate about the size of the facility available for such rescues, we see the emergence of stronger economic governance mechanisms within the eurozone.

Such a system of governance will not emerge overnight. The politics are extremely difficult. We see that in Germany's strong negative reaction to the idea of euro bonds (debt issued by

member states that is backed by the European Central Bank and thus by member states collectively). German voters do not wish to subsidize the more profligate peripheral states. The Germans might be persuaded to change their position if reforms included much stronger controls over the policies and actions of member states that receive aid, but those states, of course, might see that as

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an unacceptable intrusion into their internal business. We have seen in Greece that popular resistance to austerity can derail measures agreed upon by elected governments.

There also is the question of how stronger links within the eurozone might affect the relationship with those members of the European Union that remain outside the eurozone, including the United Kingdom, Sweden and Poland.

One should not doubt the determination of the eurozone's political leaders — especially those in France and Germany — to keep the union together and make the single currency work. But at this stage, the eurozone's future is uncertain. If it is to survive, it needs much greater economic and political convergence. It is questionable whether the voters of Europe are ready for that. ■

The views expressed in this article are those of the author and not necessarily those of FTI Consulting, Inc., or its other professionals.