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European Spring: Why Our Economies and Politics are in a Mess – and How to Put Them Right?*

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Philippe Legrain:
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As an economic advisor to former president of the European Commission José Manuel Barroso, Philippe Legrain obtained direct insight into the practices of European crisis management, the political deals emerging, and all the concerns and political interests that shaped European crisis management. The author earned his degree in economics and international political economics from the London School of Economics. Since graduation, he has worked as a journalist and written several books.

The first structural unit of the book describes the events leading up to the emergence and escalation of the European debt crisis following the financial crisis arising in the aftermath of the Lehman Brothers bankruptcy. Along with a description of European crisis management, it specifically addresses the crisis management practice of the UK, discussing similarities and differences. The escalation and prolongation of the financial crisis in Europe is attributed to a series of errors in decision making. European leaders failed to recognise that the problems were not fiscal in origin. Rather than through restrictions, they ought to have been addressed through a renewal of the European institutional system, by breaking the relationship between banks and sovereigns. The author argues that crisis management and the future of the euro area cannot follow the German example, and the European institutional system cannot be redesigned in a German approach, which is unsustainable both economically and politically.

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

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The European crisis was not caused by imbalances in fiscal policy. Turbulences in the bond markets did not increase because a set threshold of public debt was breached, but as a result of incorrect policy decisions. Following the financial disruptions in the aftermath of the American subprime crisis, after emergency liquidity injections by the ECB, concerns over the survival of the euro area had not yet surfaced. However, instead of providing fiscal stimulus, decision makers in the euro area tried to stabilise European economies through a wide range of restrictions. The author argues that the European crisis started to escalate when the possibility of Greek insolvency emerged. Due to the inadequate institutional structure of the euro area, and primarily to errors in policy decisions, the crisis reached a systemic level.

Banks should have only been rescued subject to orderly reorganisation and a review of their business policies. The author highlights the bank rescue packages following the onset of the American subprime crisis. As part of those packages, governments provided assistance on a large scale to financial institutions in distress, without the orderly resolution or reorganisation of such. In the euro area there were no common resolution requirements in place, as a result of which, despite the fact that banks' operations allowed them to grow large on a real European scale, when they were wound up their solvency had to be restored within national powers, which imposed a great burden on governments.

Greek debt should have been restructured immediately. Right from the start, it was obvious that Greek sovereign debt was unsustainable and that the country was insolvent. However, arguing that a Greek bankruptcy would lead to Lehman-style panic, European decision makers opted against restructuring the country's debt. Even after the first Greek rescue package, it was apparent that Greece remained insolvent and would need further assistance shortly. Decision makers also refused to write off part of the debt on grounds of the 'no bail out' clause of the Treaty. The refusal carried the message that other European countries could also become insolvent in the event of their inability to refinance their debt.

Forced crisis management aimed at fiscal balance was harmful and failed. Following the Greek rescue package, European decision makers opted to implement a wide range of rebalancing measures. With subdued demand from the private and financial sectors, government restrictions resulted in a deep recession, while at times of turmoil it was only governments that could have generated additional demand in the economies.

Confusing the problems of illiquid countries with Greek insolvency only exacerbated the crisis. When Greece was bailed out, it was proposed that going forward, countries in distress would be aided using community funds, with the involvement of the private sector. Under that proposal, member states that were forced to seek assistance due to turbulences caused by market disruptions rather than insufficient

economic fundamentals (such as Spain and Italy) would be allowed to shift losses on the private sector. As a result, the crisis spilled over to other countries, and European government bond yields continued to soar.

Raising the possibility of Grexit was a bad decision. Liquidity had been provided to Greek banks by the ECB, discontinuing which would have forced the country to exit the euro area. As a result, the euro was no longer trusted as an irreversible single currency.

The consequences of the above policy decisions caused the government bond yields of each country to increase. Given that government securities account for a significant portion of European banks' balance sheets, the impairment of such caused financial institutions to incur major losses, requiring them to seek assistance from the state, which in turn increased government bond yields further. That is, the negative feedback process between banks and sovereigns destabilised countries.

Crisis management based on the German model was founded on erroneous assumptions and failed to resolve the problems of the euro area. Over the past 15 years, the German economy made considerable progress, primarily by means of an artificial brake on wage growth. Wages did not grow at the same rate as the productivity of the German economy, which gradually improved Germany's competitiveness and generated a huge current account surplus. The author considers that surplus to be harmful, arguing that except for Greece, southern countries were not destabilised as a result of their excessive indebtedness, but rather by Germany's excessive savings. Due to insufficient domestic demand for credit, German capital created asset price bubbles in southern countries. The author finds fundamental flaws with the German position that southern countries should recover their competitiveness and increase their exports through internal devaluations, i.e. by cutting labour costs. The German model cannot provide a solution for the European Union as a whole. The EU is the largest market in the world, and as such it must not generate an excessive current account surplus, since those surplus exports should also be consumed by some countries, for which there is no real chance.

The crisis of the euro area was finally put to an end by ECB President Mario Draghi's speech on his commitment to preserve the euro. Soaring European government bonds collapsed immediately. The main problem was therefore caused by the fact that as opposed to other countries, the central bank of the euro area was not mandated to act as a lender of last resort. This in turn meant that countries in distress had to be rescued through fiscal policies, which resulted in unsustainable social and political tensions.

For the sake of the euro area's future, the shocks caused by the debt crisis must be prevented, its consequences must be mitigated, and losses must be distributed in a transparent manner and as decently as possible. For the preservation of euro area, the author considers four institutional arrangements to be viable: the prevalence of the German approach, a technocratic future, a federal euro area, and a flexible euro area. The German approach foresees increased German dominance, a stronger coordination of fiscal policies, and German-style measures to rebalance and improve competitiveness (wage cap), accompanied by a minimum level of shared risk and solidarity. The technocratic arrangement involves an operational banking union, centrally supervised fiscal rules, the introduction of Eurobonds, and a stronger dominance from Brussels in setting economic policies. In the federal approach, a European Central Treasury would be set up, which would collect tax revenues in its own right, allowing it to issue debt of its own, which would be a safe asset in times of crisis. Additionally, the Treasury could provide fiscal incentives, and the ECB, in its role as lender of last resort, could support the sustenance of trust in central debt. The fourth option is the creation of a flexible euro area, which involves a comprehensive banking union, and stronger coordination accompanied by the preservation of autonomous fiscal policies. In this case, in its role as lender of last resort, the ECB could support illiquid member states, while the debt of insolvent member states would be restructured under IMF supervision.

Of the possible visions, the author considers the federal approach to be the most ideal one, which, however, is not a realistic outcome in the current political climate. The second best approach would be a flexible fiscal union, but that also raises the question of how much autonomy each institution should enjoy. To what extent would the single supervisory mechanism give equal weight to addressing the problems identified in various member states? Would insolvent member states subject themselves to IMF schemes? How long would the ECB grant assistance to illiquid member states in the event of Germany's possible protest? The author argues that we are heading in the German direction, with technocratic additions. That is, the community institutions are being set up, but are used by Germany to promote and enforce its own will and policy. That means to improve competitiveness and to establish export-oriented economies, primarily by cutting wage costs. However, the German technocratic arrangement is politically unsustainable, as it undermines democratic support for the single European project and will ultimately lead to a new crisis across the region.

The economies of the euro area and the UK are facing similar difficulties. The author compares the crisis of the UK to that of the euro area, and finds that their problems are shared in several aspects. In both economies, subdued corporate lending and moderate growth pose a severe problem. The problems in both economies are attributable to insufficient crisis management. In the UK, growth failed to recover

despite the absence of a bond market crisis. In most cases, the UK approaches problems from a Washington perspective, but its response to the economic crisis was definitely European in the form of severe rebalancing measures. As a result of the restrictions, demand in the UK plunged, while the fiscal balance failed to improve. The government ultimately abandoned fiscal adjustments. Attempts to generate additional demand were made through the support of the Bank of England's large asset purchase programme. However, this failed to bring about a meaningful improvement in growth prospects. Consequently, the UK is facing difficulties that are similar to those of the euro area. The author highlights moderate growth, high unemployment and subdued corporate lending.

In the second structural unit of the book, the author discusses the challenges that the EU and the UK must meet in order to lay the foundations for economic success. Europe's problems result from the poor adaptability of the economy, low growth potential, the consequences of aging society, the culture of risk aversion, and the fact that the interests of the political elites contradict changes. Following the discussion of the problems, the author proposes the implementation of so-called ADD (adaptive, dynamic and decent) reforms. In order follow up on past successes, the European continent needs economic and political change; a European spring.

The economy suffers periodic shocks, both internal and external. As the market economy and the financial system are essentially stable, it is the adaptability of the economy that needs improvement. The risks stemming from the financial system need to be mitigated by increasing the quantity and quality of capital. The mobility of the factors of production and of labour in particular need to be improved so that they are utilised where they are needed the most. The standardisation of markets and the abolition of unnecessary regulations enable competition to become more intensive, giving companies incentives for efficient operations. Therefore, the adaptability of the economy to various shocks must be improved.

Economic growth must be facilitated, and the dynamism of the economy increased. Growth requires more innovation, more start-ups, and more initiatives. To that end, entrepreneurship in society must be strengthened from early childhood. Education plays a key role in shaping creative thinking and an enterprising spirit. In public and higher education, efforts must be made to foster creativity and develop entrepreneurship. Innovation emerges in proportion with the density of social connections as part of social interactions. This is why innovations occur primarily in cities. As a result, the number of human interactions and the density of human connections must be increased. Apart from all this, the required funding also needs to be provided. The conditions for access to funding by start-ups must be provided. The government must develop government services and must spend more on research and development. The ability of the economy to grow can be improved with the support of new ideas and innovations.

European social values must be centred around equal opportunities. Society works the most efficiently when every individual has equal opportunities to accomplish the objectives set. The state must therefore reduce the differences between individuals by supporting those in distress. Excessive differences in income must be eliminated. Incomes should be determined on the basis of social utility. Efforts are needed against undeserved revenues; therefore, taxes must be levied on land, and agricultural subsidies must be reviewed and discontinued. With a view to the most efficient use of resources, granting equal opportunities must be given priority in society.

The author argues that rather than through German-style restrictions and the UK's asset purchase programmes, European competitiveness should be restored by means of measures facilitating the adaptability, growth potential and decency of the economy. And that requires radical economic and political changes, i.e. a European spring.