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The Eurozone Crisis: Update and Outlook

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Seoul, October 29, 2012



Genealogy of the Eurozone Crisis

▪ **European Union an unfinished, experimental construct**

"The European Economic Commission, the Council, [European] Parliament, the Court of Justice are a pre-federal model. But they are not the organs of a political federation of Europe that will eventually arise from a specific creative action that will require a new delegation of sovereignty. There will be a need to go back to the sources of power, first to complete the economic union that has been deprived of its momentum for too long, and then to seek the shape of a more complete and deeper union [...] What we are preparing through the [European] Community probably has no precedent. This Community itself rests on institutions that need reinforcing. But we must also keep in mind that the genuine political authority that European democracies will grant themselves one day remains to be designed and implemented."

Jean Monnet, *Memoirs*, 1976

▪ **Single currency introduced with incomplete policy framework**

- Bundesbank dominance + German reunification
- Lax admission of members

▪ **Complacency in the 2000s**

- Flouting of Stability & Growth Pact by France and Germany
- Divergence of competitiveness between north and south
- Unchecked credit expansion / bank leveraging / financial nationalism



An Analytical Framework

- Fourfold agenda: cf report by European Council President Herman Van Rompuy, June 26, 2012

Loss of trust	Aim	Label
Dysfunctional interbank market	Restore credit	Banking Union
Credit risk on sovereign securities	Buyers for govt debt	Fiscal Union
Sclerotic economies	High-growth firms	Economic Union (?)
Policy paralysis	Effective / legitimate institutions	Political Union

- Resulting doubt about Eurozone sustainability: "redenomination risk"
- Progress needed in parallel on four fronts
 - None a substitute for others; none to be achieved in one step
 - Hugely complex endeavor



Short Term / Long Term Challenges

▪ **Crisis management**

- Banking fragility, 2007-09
- Greece, late 2009 / early 2010
- “Private Sector Involvement” Deauville, Oct 2010
- Irish assistance package, Nov 2010
- Direct recapitalization of banks by European Stability Mechanism (ESM), announced June 2012
- ECB always the default crisis manager

▪ **Long-term transformation of European institutions**

- Legitimacy / accountability at the European level
- Capability for decision / implementation / checks & balances
- Financial resources
- Geographical perimeter



Banking Union

- **Longstanding calls for banking policy integration**
- **Trigger 2011/early 2012: “Doom Loop”**
 - Government guarantee of banking systems
 - Banks’ portfolios of government debt
 - Financial fragmentation (repression): ECB analysis
- **Sequence (summits of June 29 + Oct 18)**
 - Step 1: Single Supervisory Mechanism
 - Step 2: Direct recapitalization by European Stability Mechanism (ESM)
 - Step 3: Resolution authority / deposit insurance
- **Single Supervisory Mechanism**
 - Aim to reach agreement by January 1, 2013



Europe's Financial System: Structural Change

- **A decade of adjustment**
 - Much restructuring under the radar + constant regulatory change
- **Fragmentation / integration**
- **Banking consolidation**
 - In many cases delayed by nationalization
 - But many govts will exit as soon as market conditions allow
 - High levels of intra-country concentration
 - Entry of new players (private equity / de novo banks)?
- **Non-bank credit**
 - Credit needed in long phase of bank deleveraging
 - New demands of (increasingly) service economy
 - But risk of repression: “shadow banking” discussions to come



Fiscal Union

- **No clear direction yet**
 - Mutual guarantees + common discipline
 - Central guarantee / restructuring mechanism
 - Fiscal federalism
- **EFSF (2010)**
 - Borrowing facility with national guarantees
- **ESM (2012)**
 - Treaty-based
 - Paid-in capital
 - But limitation on size + decision-making
- **Lessons from US / others**



Structural Reform / Competitiveness

Policy area	EU	National	Local
Labor mobility / flexibility / fairness	√?	√√√	-
Financial system / equity and credit	√√	√√	√
Insolvency law	√?	√√√	-
Competition policy implementation	√	√√	-
Regulation of industries and professions	√	√√√	√
Innovation ecosystems / education	√	√√	√√√

- **How much coordination is needed at European level?**
 - Is peer pressure sufficient?
 - Lessons from "Lisbon Agenda" / "Agenda 2020"
- **Long learning curve ahead**
 - e.g. retirement frameworks



Political / Institutional Challenges

▪ Core challenge of representation / accountability

- Europe's twin deficits: executive / democratic
- German Constitutional Court: Lisbon Treaty ruling, June 2009
 - European Parliament: inequality of representation + limited powers
 - "[... the European Parliament] therefore cannot support a parliamentary government and organise itself with regard to party politics in the system of government and opposition in such a way that a decision on political direction taken by the European electorate could have a politically decisive effect. Due to this structural democratic deficit [...]"

▪ Diversity of attitudes among member states

- Germany, Italy vs France, Spain
- The UK question

▪ Political volatility

- Abrupt shifts in partisan alignments / political economy
- Rise of separatism?



Next Steps

- **Economic outlook**
 - “Redenomination risk” (i.e., integrity of Eurozone) is the key
- **Banking Union**
 - Finalize legislative compromise + ESM intervention
- **Country hotspots**
 - Spain: new assistance program likely
 - Greece: now given benefit of doubt, but what if no real change?
 - Italy? France?
- **Treaty change(s)**
 - Discussion barely started, contentious + ratification risk
- **Overall outlook**
 - Different views on cultural/historical determinism



Thank You For Your Attention

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