EUROZONE GOVERNANCE AFTER GREECE: LESSONS LEARNED, LESSONS TO LEARN

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Introduction

The Greek debt crisis forced a rushed rethink of whether eurozone governance had proven "fit for purpose". The institutional engineering that ensued, unprecedented in both scale and in pace, set up new surveillance systems for budgetary and economic policies, and a new budgetary timeline for the euro area. The creation of stability mechanisms and the confident emergence of the ECB as a key player with a "whatever it takes" attitude all helped weather a crisis which very quickly turned systemic. The fact that Greece became the "catalyst" for reform inadvertently influenced the gamut of the measures taken – it also sealed their short-termism.

Today, the crisis has seemingly subsided and many of its effects on national economies have theoretically been addressed. It remains a moot point, however, whether the new governance can withstand a new crisis or whether it can contribute to a return to pre-crisis growth. Risk sharing has hardly ranked high in reformers' attitudes and investment tools have not necessarily reached those most in need. At the national level, the political will to continue on the path of fiscal prudence or on the path of structural adjustment or to coordinate the two is rapidly waning. This paper will argue that "modelling reform" on the Greek case has led to the kind of governance that lacks both a coherent vision of economic and monetary union and the tools for completing it. Arriving at a stable equilibrium, where "rules" are matched with "solidarity" offers a far more sustainable route, one that speaks to concerns about both democratic legitimacy and the long-term economic health of currency union members.

Greece: catalyst, scapegoat, prototype?

All was never well with eurozone governance. During the "good EMU years", large cross-border capital flows went unnoticed and unchecked, while a number of governments casually defied the kind of fiscal discipline espoused in the Stability and Growth Pact. Problems of set-

up – no lender of last resort, negligible labour mobility, no common fiscal policy – went hand in hand with divergent behaviour, evidenced in, among other indicators, the different growth rates of wages and productivity between north and south. Greece did fail to put its fiscal house in order during a period when long-term interest rates declined steeply and clever management could have resulted in its debt to GDP level being put on a downward path. Greece, however, was hardly the only country on the periphery to misinterpret low interest rates as an invitation to embark on a private and/or public spending spree financed by the banking sectors of the core countries.

When the crisis hit, Greece's fiscal misbehaviour was singled out, both by the markets that had regularly refinanced Greek debt, and by eurozone partners and institutions that had casually turned a blind eye to Greece's recurring budgetary problems and poor statistics. Poor crisis management ensued: shielding the eurozone against "fiscal delinquency" offered a relatively facile approach to solving a crisis that was novel and unexpected. Even when eurozone elites reluctantly made provision for a "fire brigade", "punishing the guilty" (De Grauwe, 2010) became the overarching consideration. The markets, which were suddenly able to see the "wider picture", attacked the next weak link; contagion inadvertently set in. Eurozone elites discarded the uncomfortable realisation that the rules – no default, no bailout, no exit – proved to have been too tightly constructed; more importantly, they proved unwilling to understand the level of interdependence between the eurozone economies and the fragility that went with it (Panagiotarea, 2013).

The narrative of profligacy, which partially "captured" Greece's misbehaviour, came with at least three flaws. First, compliance with the Stability and Growth Pact did not necessarily correlate with whether a country ended up with a bailout programme or not. Ireland and Spain, poster children for fiscal prudence until 2007, ended up requesting their own bailout packages. Moreover, Belgium and Italy, the countries with the highest debt-to-GDP ratios (except for Greece) were able to sail through the eurozone crisis unharmed. Second, this narrative failed to account for the major financial imbalances that were accumulating, as large intra-eurozone capital flows built up for a decade and too much private and public debt was borrowed from abroad. The "sudden stop" in cross-border lending, a corollary of the international financial crisis, saw risk premiums rise and the banks and governments which ran huge current account deficits were severely targeted by markets. This "consensus narrative of the Eurozone crisis" (Baldwin *et al.*, 2015), unfortunately arrived rather late in public debate, when fire fighting and institution building (related to *this* stage of the crisis) were close to completion. Third, the profligacy narrative failed to account for what could be termed the "original sin" asymmetry: the structural heterogeneity that existed between the members of the monetary union at the point of entry, which was manifested by a number of diverging trends, including in their industrial base and trade patterns.

With hindsight, eurozone leaders who stuck with the "it's mostly fiscal" narrative (Constâncio, 2013) were always behind the curve, embarking on an institution-building process that merely "responded" to market pressures. Although the publicly stated intention was to ensure the financial stability of the eurozone as a whole, arriving at "stability"

became equated with institutionalising fiscal discipline. The Stability and Growth Pact, supplemented by the Fiscal Compact, the adoption of the so-called "six-pack", the Treaty on Stability, Coordination and Governance, bolstered by the "two-pack", were all grounded in the European Semester, the EU's policymaking calendar. The fact that Greece was held up as the prototype explained the drive to generate clearer rules, better coordination of national policies throughout the year, regular progress follow-up and swifter sanctions for breaching the rules.

Tightening up rules that had failed in their "lighter version" or creating new ones with similar logic was supposed to insure against moral hazard, eliminate the possibility of future sovereign defaults, and restore public debt sustainability and competitiveness. In the absence of parallel moves towards fiscal federalism or debt mutualisation, this "approach" betrayed a continued ignorance of member states' divergent economic models and how they affected national performance, misunderstood the capacity of their economies to respond to the "new" rules, and miscalculated the limits of the political capital that could be used in the process. In addition and irrespective of the window-dressing that took place, serious economic and political objections lurked (and continue to lurk) dangerously beneath the surface: the EU has no fiscal capacity, yet it has acquired a strong regulatory power to control national budgets (Hallerberg, 2014).

Do rules work? Complexity, ownership and enforcement

The strategy that has followed – fiscal consolidation and structural adjustment as the panacea for all evils – has yet to provide a meaningful return to growth or a rebalancing of divergences among member states. It has also made a dent in European solidarity, as some countries continue to shoulder a greater burden of adjustment than others. A stability culture has indeed been introduced. One, however, that does not offer a credible solution to the legacy issue: a number of countries have accumulated large public debts and the tools or the growth levels to bring them down are simply not there. Greece has experienced the worst of all worlds: fiscal consolidation has come at a steep price – the country has lost 25% of its GDP, and unemployment is stuck at 24-25% (with youth unemployment at 50%). Greece's public debt is projected to rise to 185% of GDP in 2016, when it was 120.6% at the time that the country applied for economic help. Uncertainty about the ability of the country to implement its third bailout programme, combined with uncertainty about its ability to service its huge debt load, provide little hope that Greece can return to meaningful economic recovery in the short term.

As for the eurozone, some voices suggest that one of the reasons for *its* economic recovery (leaving aside how slow or sustainable it is) lies in the fact that "spending and growth are now under less pressure from fiscal consolidation" (Eichengreen, 2015). This is tricky, as officially, fiscal policy is expected to continue to play a supportive role in the recovery.[1]From here emerge the questions of "whose fiscal policy?" and "how do we apply the rules?" How do authorities come to decide which countries will be *exempted* from the rules, with exceptions typically justified in the context of "propping up a recovery" or "ensuring that a given economy

1. European Economy 2016 "European Economic Forecast" *Institutional Paper 020*, Winter, http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip020_en.pdf.

does not fall back into recession"? Strict application is supposed to work as an anchor for financial markets, or to facilitate a regime change towards lower debts and deficits. Uneven application inevitably leads to bitter criticism of "double standards".

Greece certainly constitutes a "case" in this respect. Fiscal consolidation is at the centre of each bailout programme; in fact, the continuation of fiscal consolidation is a prerequisite for the continuation of aid. If, however, fiscal consolidation is the only available policy option in some cases, and fiscal slippages are casually allowed in others, then the credibility effects that the revamped governance mechanisms are supposed to trigger will simply not materialise. In addition, the absence of policy options, and the absence of democratic oversight over the "institutions" that dictate the available options, raise serious legitimacy issues; these are unfortunately exacerbated, at least in Greece, by the way successive governments have chosen to rein in budget deficits: careful to protect public sector clienteles, they have repeatedly opted for measures that end up shutting the most vulnerable out of social provision or penalising consistent taxpayers.

In reality, the "sanctity" of rules has been repeatedly bashed on the ground; the relevance of rules lies more in how they are disputed by large and small countries alike than in how they evaluate policy outcomes against agreed and quantifiable benchmarks. This is evident in the way the six-pack allows national governments to exercise significant discretion. At least "allowing" discretion within the system reduces, it has been argued, output legitimacy issues that arise from stricter intrusion – the idea that more intrusion leads to better ability to deal with externalities has not been backed up by evidence (Alcidi et al., 2014).Nonetheless, as "discretion" invites uneven application it constitutes an approach to "discipline" which recalls the way "sanctions" were (not) applied under the pre-crisis Stability and Growth Pact. Equally, it remains to be seen whether penalties will be levied against countries that post excessive imbalances, with the Macroeconomic Imbalances Procedure appearing to be "blind" when it comes to determining current account surpluses. In this context, the European Semester "has been rather ineffective" (Darvas and Leandro, 2015) as a policy coordination system and as a mechanism to enforce the overhauled fiscal rules and the new macroeconomic imbalance rules; national interests continue to define how recommendations are interpreted or implemented, repeating political asymmetries of the past and negating any meaningful policy implications.

It is safe to assume that institutionalisation will increasingly become harder to defend, let alone sustain. For one, anti-European sentiment is rising right across the board, as Eurosceptic and populist parties continue to make gains by aligning "Europe" with unpopular tax hikes, spending cuts and stagnation. Anti-austerity forces gain power on agendas to temper deficit targets, while governments which oversaw programme "exit" are habitually toppled; the risk of jeopardising "progress made" and rattling investors in the bond markets appears to be palatable to voters. Moreover, the migration crisis, which shows no signs of abating, will inevitably stretch fiscal policies and undermine compliance with rules, impacting on public finances and labour markets. Even if the evolution of migrant flows is hard to estimate with any

certainty, international organisations assume that they will most likely be concentrated in specific countries.[2] Those still facing high levels of unemployment or those which have no fiscal space –with Greece a prime example – will be the first to feel the pressure to scale up spending while simultaneously being expected to maintain fiscal discipline. The effect of these conflicting pressures will be fed right through party systems which seem to be in fragmentation "mode". This mode will probably gain further traction as populist sentiments become more mainstream and established parties choose to scapegoat "Brussels" and their "fiscal diktats" in order to maintain their voting base.

Rules and solidarity: Can they be balanced?

Is there momentum for change? Greece can no longer be used either as a pretext or as the perfect specimen for experimentation. For the whole of 2015, GDP rose by 1.5% in the euro area,[3] while public debt (Q3 data) was at 91.6% of GDP;[4] anaemic growth offers no guarantee that deficits can be managed or that debts can become sustainable. More importantly, Europe is facing a continuum of crises, one feeding into the other, and all highlighting how the European project's internal cohesion is at stake. The legacy of crisis management in the eurozone, particularly in the handling of Greece, is casting its rather dark shadow: the strong resurgence of intergovernmentalism, which politicised financial support and dictated "burden-sharing"; the "kicking the can down the road" principle prevailing in the absence of a coherent strategy and a unified vision; and the depletion of EU assets (including trust in and credibility of proposed policies) compared to the political capital that national governments are expected to exert in order to push through measures at the heart of national sovereignty.

In addition, the migration crisis – Greece is once again at the epicentre – is bringing into focus all the unresolved matters that the new economic governance brushed under the carpet: the absence of a mechanism to allow member states to absorb asymmetric shocks; the area's difficulty demography; its limited labour market mobility. A return of the Greek crisis cannot be ruled out, particularly if the EU-Turkey agreement is not enforced in a credible manner and Greece's European partners fail to abide by the relocation scheme. Terrorist attacks will inevitably transform Europe's migration debate into a security one, with the Schengen open borders policy coming under further strain. The implications for fiscal discipline, the effects of a possible reintroduction of internal border controls, the public security measures that will be put in place and the higher expenditures they will necessitate are all expected to weigh heavily on economic growth, further questioning the governance structures put in place.

Even as the sense of urgency is growing, the force of inertia appears stronger. National politicians appear willing to go down the à la carte path, as they stumble upon the limited appetite for further integration and as public debate is increasingly captured by the popularity of anti-European parties. In today's circumstances, however, the convenient and well-rehearsed retreat to the maximisation of the national interest raises the possibility of the European project's accelerated erosion if not collapse. Questions of sovereignty sharing and democratic legitimacy

2. OECD, "Is this humanitarian migration crisis different?", *Migration Policy Debates*, no. 7, September 2015.
3. Eurostat newsreleaseeuroindicators2016 "Flash Estimate for the fourth quarter of 2015", 32/February 2016. http://ec.europa.eu/eurostat/documents/2995521/7156138/2-12022016-BP-EN.pdf/bba8f85f-cab6-4482-a3a4-29bc087cec42
4. Eurostat newsreleaseeuroindicators2015 "Government debt fell to 92.2% of GDP in euro area", October 2015, 187/October. http://ec.europa.eu/eurostat/documents/2995521/7049759/2-23102015-AP-EN.pdf/76641d4c-af11-4fc4-b78f-94aaa633b8c3
5. European Parliament,"The ECB's Expanded Asset Purchase Programme: Will quantitative easing revive the euro area economy?", February 2015. http://www.europarl.europa.eu/EPRS/EPRS-Briefing-548976-The-ECBs-EAPP-FINAL.pdf

require urgent answers, particularly when a culture of disunity is taking hold: unilateral moves trample on collective decisions, borders are closed, and economic aid is expected to compensate for the absence of a truly "European" response. This will only exacerbate the widespread discontent of Europeans who do not experience Europe's institutional interference in national policy as "win-win" for all.

The most prudent way going forward is to strike the right balance between rule-following and showing solidarity, forging a medium-term political deal to promote sustainable growth. If the eurozone can deliver on growth, then it can help reinstate the central organising ideas of stability, security and trust that Europeans associate with belonging to a single currency. This deal should involve, first, correcting or rather fine-tuning the policy mix. The ECB's QE programme has supported demand, yet lower yields have not really pushed funds and banks to take risks with private sector investment. It is not just that with the exception of Greece, interest rates on euro area government bonds have kept falling since July 2012;[5] the banking sector's willingness to lend to the real economy – it finances about 80% – is ultimately weakened under the current strained financial conditions and a global push to maintain or increase capital buffers. The ECB needs to acquire some tools that are available to 'typical' central banks, if it is to move towards the currently unreachable inflation target of close to 2 percent, while avoiding the collateral damage that will be eventually triggered by excessive reliance on negative interest rates and the QE programme.

National fiscal policy should be strongly counter-cyclical and where fiscal stimulus is due, an effort should be made for it to be coordinated across countries. Coordination, however, should not be confused with arriving at a rigid EU-wide fiscal stance – particularly when the "technocratic" oversight of rules that are far from "fixed" accentuates "democratic deficit" issues, or when stabilising functions are still lacking at euro area level. For the sake of garnering confidence and protecting future generations, fiscal discipline must be repackaged in a fiscal sustainability frame, ensuring the long-term sustainability of public debt. The Greek experience, particularly the problematic ownership of the reform programmes, points to the putting in place of binding national incentives, including national rules to improve the efficiency and quality of public spending. These would help affirm fiscal responsibility vis-à-vis the common project, assuage moral hazard fears, and promote, more generally, mutual trust among debtors and creditors. Structural adjustment efforts must also be reframed and re-energised to finally help economies make the "transition towards new systems of production and consumption"(Mortensen and Alcidi, 2012).

To support the countries experiencing reform fatigue, to compensate those whose fiscal consolidation has cost them lower public consumption and transfers, to help solidify the recovery in others, in essence, to honour the deal for sustainable growth, another policy priority should be to expedite the investment plan for Europe. Greece offers an extreme example in this respect; its disinvestment trajectory has been magnified by the ongoing adjustment, while Greek companies continue to suffer from limited credit and the real interest rate, low productivity, limited extroversion, and an unstable tax and regulatory environments trajectory. For private investors to actively leverage the admittedly limited European

6. European Commission "European Structural and Investment FUNDS and European Fund for Strategic Investments complementarities", 2016. http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/efsi_esif_compl_en.pdf.

and national public investment funds, therefore, a concerted effort at both national and EU levels should be made to improve the business climate, guarantee the smooth operation of the internal market, and create a fair regulatory environment that cuts red tape and bureaucratic burdens. Breaking away from the loose, non-transparent practices of the past, targeting investment in R&D and key infrastructures should maximise positive effects and/or create positive spillover effects; given the size of the investment gap in Europe, regularly measured at 15% below pre-crisis levels,[6] countries with large current account surpluses should seek to prioritise investment.

Obviously, completing the banking union, the third aspect of the deal for growth, would provide the stable and robust banking sector and the well-functioning capital markets that would channel accessible credit to the real economy. As countries in the eurozone have to stimulate their economies – careful not to binge on public and private sector borrowing or to create a new set of bubbles – the operation of a real Capital Markets Union would tackle investment shortages and provide much needed finance to the companies that struggle to get funding, particularly SMEs and start-ups.

Moving to a mode of governance promoting sustainable growth should make way for enhanced coordination structures, including stabilisation tools/insurance schemes for employment and social protection at European level. Job creation has yet to feature in the current modus operandi, while "internal devaluation" has predictably not worked as expected (aggregate demand has been dragged down), reallocating labour to more productive sectors is cumbersome, and trade surplus countries refuse to coordinate on their wage and price policies. National governments hold the key: they are and should be held responsible for aligning wage costs to productivity, alleviating heavy social insurance and tax burdens, and creating a non-burdensome business environment. Unfortunately, in Greece the way "adjustment" has been pursued has protected rent-seeking regulation, preserving oligopolistic structures in product markets, and increased the cost of introducing innovation into production and supply lines (Pelagidis and Mitsopoulos, 2014). For governments that fail to link reform with growth, but also for those trying or struggling to find the appropriate equilibrium, governance could generate a supporting buffer: repairing the financial system via the completion of the Banking Union could enhance the effectiveness of employment programmes; cohesion policy could facilitate a reindustrialisation strategy in the weaker members of the eurozone; productive investment could smooth the transition from activities in the non-tradable sector and employment in the public sector to high value-added activities. The rebalancing of the policy mix mentioned above could endorse a job-friendly fiscal policy by cutting down on wasteful spending, adopting tax measures that broaden the tax base and shielding against social security contributions that burden labour income and investment.

In addition, a European unemployment benefit scheme, designed as an automatic stabiliser mechanism that is effective in the short term, could protect against the increasing cost of economic and social marginalisation evidenced in countries with persistently high levels of unemployment, with Greece being a prime example. A concrete manifestation of European solidarity, this mechanism could be built up with an eye to pre-empting moral hazard objections, employing specific

7. Panagiotarea, E. 2015 "Eurozone Governance for the European People: Towards a path to sustained prosperity", Policy Brief, ELIAMEP 12th European Seminar, *The EU and its discontents: Is the European Project sustainable and/or adaptable? September*

triggers when authorising transfers and utilising a "claw-back" principle based on benefits accrued (Beblavý et al., 2015).In this way, it could fill in national gaps – national stabilisers failed to absorb shocks during the crisis (Dolls et al., 2014) –and compensate for the limited labour mobility in this monetary union (Barslund et al., 2015). Given the absence of appetite for a prior harmonisation of labour markets – usually considered a "prerequisite" for a benefit of this kind – another option on the table could be a pan-European flat provision, handed out on the basis of commonly accepted principles to promote income security.

Finally, there is the issue of setting up a fiscal capacity, though the road set out for a fiscal union in the Five Presidents' Report remains bitterly disputed. The heterogeneity of national economies should be the background condition against which alternative options should be explored, particularly in "an area where counter-cyclical automatic stabilisation only partially compensates for pro-cyclical discretionary policy" (Bénassy-Quéré et al., 2016). Such a capacity could provide, particularly for countries like Greece that are in seemingly permanent, self-defeating austerity mode, the fiscal space to spend on productive investment and on social programmes targeting poverty and social exclusion. It could also work as a safety net or as an incentive structure for renewed efforts at stabilisation. Finally, it could insure against severe downturns or asymmetric shocks, the danger of which is very much visible. Putting in place caveats would shield against moral hazard and trim government incentives to free ride on others' fiscal responsibility. This could involve creating clear and transparent rules for the transfer of resources, agreed *ex ante*, raising funds for the fiscal capacity in the markets via a diversified strategy, and using a variety of instruments and maturities to ensure the efficiency of funding and continuous market access, as well as linking transfers to quantifiable progress in economic performance and competitiveness within a euro-level agreed time horizon.[7]

Conclusion: Making governance fit for purpose

Europe's crises multiply and impact on one another, and yet the urgency of reform keeps eluding eurozone elites and policymakers. Eurozone governance is caught between a partial and therefore distortive narrative of fiscal profligacy and growing divergence on the ground – in terms of rule-following and economic performance. Greece remains stuck in an adjustment quagmire. Even the successful PIGS, those that have exited their programmes, continue to grapple, politically or economically or both, with the fallout from unequal burden sharing. The relative calm that has prevailed, following the near-Grexit episode of July 2015, is providing a false sense of security that governance works, even if the euro area is far from arriving at a path of sustainable growth *for all*.

The added-on migration crisis will, however, inevitably impact on rule-following and further strain current structures at a time when the external environment for the euro area as a whole has turned less than favourable. China is struggling to rebalance towards a consumption-driven growth model, global financial market volatility has re-emerged, uncertainty clouds the US's rate-hiking path, geopolitical tensions persist and commodity prices have dropped sharply. Member states are left vulnerable to negative spillovers "via various transmission channels".[8]

8. European Economy, "European Economic Forecast", *Institutional Paper 020*,winter 2016. http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip020_en.pdf.

The need for a "grand bargain" regularly surfaces in public debate, only to be crushed. This happened most recently with the cold reception of the Five Presidents' Report on the Economic and Monetary Union.[9]In any area requiring "reform" the goal has become, at best, to arrive at the lowest common denominator. The price of inaction is nonetheless high and already evident in the steady ascendancy of unilateralism. A positive narrative to shift perceptions and expectations could provide a humble restart. Coordination and national sovereignty, sustainable growth and solidarity should be placed at its centre, backed up with solid instruments to support the move to a *more complete* monetary union. Bringing back real convergence holds the key: economic governance should provide both the incentives for the exercise of national responsibility and a European safety net that balances supervision and protection.

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9. European Commission, "The Five Presidents' Report: Completing Europe's Economic and Monetary Union", 2015.https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en.

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