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***Saving the Euro:  
Policies, Institutions, and Politics in the Eurozone Crisis***

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The “Great Recession” that followed the collapse of American Lehman Brothers in 2008 impacted Europe and Canada in different ways. Flaws in the EU’s Economic and Monetary Union (EMU) meant that the global financial meltdown fed a second, and different, Eurozone crisis. The austerity policies chosen to combat this, shaped by the specificities of EMU and EU institutions, have been controversial. In contrast, Canada had a relatively unthreatening “first crisis” after 2008 and no “second crisis” at all. The pertinence of the EU’s Eurozone crisis policies to Canada is therefore not direct, but nuanced. This brief will focus on the policies and institutions central to confronting the Eurozone crisis, and the results.

**The Eurozone Crisis and Policy Responses**

The collapse of the international financial sector after Lehman Brothers initially seemed manageable to the EU through bailouts and stimulus plans. The Greek situation revealed

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in October 2009 showed that this was not the case, however. Greece's immediate problem was the abrupt announcement by a new left Greek government that its centre-right predecessor had cooked the books and lied about Greece's budget deficits and debts. Greece's longer-term problem was a recurrent current accounts deficit that symbolized a general failure of economic convergence with the EMU: The country had over-borrowed, mainly from northern European banks, taking advantage of EMU's one-size-fits-all interest rates to finance growth and consumption with insufficient consideration for enhancing productivity. In the global financial crisis, with growth stopping practically everywhere and spending on automatic stabilizers shooting up, cross-border capital flows slowed dramatically, leading to a "doom loop" between Greece's weakened banks and government. Greece's abysmal economic data then led financial markets to raise risk premiums on Greek bonds, pointing to insolvency. The Eurozone itself had few tools for coping with this because it had no lender of last resort, forbade internal financial solidarity, had few crisis provisions, and deprived its members of the possibility of devaluing their currencies.

After months of inconclusive discussion, the Eurogroup and European Council finally decided in May 2010 to "save the Euro," motivated by another rapid rise in risk premiums on Greek debt and the vulnerability of the northern EMU banks to a Greek default. The policies chosen focussed on rapid reduction of Greek debt and the elimination of current account imbalances. First of all, this meant cooperation between Eurozone members, the EU Commission, and the IMF to create a new institution - the European Financial Stability Facility (EFSF), which later became the European Stability Mechanism (ESM) - to provide large loans to Greece (and, subsequently, to Ireland, Portugal, and Cyprus). These loans came with stringent conditions about recipients' fiscal and budgetary practices, structural reforms enjoining budget cutbacks (in ways that would raise unemployment and block new growth), and "internal devaluations" until national finances returned to order. Their implementation was closely supervised by a *troika* made up of EU, ECB, and IMF representatives. The argument for this approach, derived from German ordoliberal ideas, was that it would eventually re-establish competitiveness, diminish Eurozone divergence, and lead to new financial stability (see Baldwin and Giavazzi 2015).

The loan programs also came with steps to correct the governance flaws in EMU, in particular its weak mechanisms for obliging members' observance of EMU rules. A new "European semester" obliged EMU members to submit budgetary plans before they were voted nationally to allow review by the Commission and other EU institutions. A "six-pack" and "two-pack" of new EU Directives instituted closer, more sophisticated oversight of national financial practices backed by new penalties where needed. A new "fiscal compact treaty" committed EMU members to balance budgets. Finally, there would be a new Banking Union containing new supervision and procedures to allow regulated bank failures. The European Central Bank participated fully in negotiations and also pursued accommodative monetary policies, including low interest rates and

quantitative easing programs. Mario Draghi's 2012 pledge that the ECB would "do what it takes" was a decisive moment in calming the markets.

### **Alternatives?**

The alternatives most often proposed shared "neo-Keynesian" arguments that a more aggressive macroeconomic approach to inject greater demand into Eurozone economies would shore up consumption and growth and allow worst-hit Euro members to avoid brutal austerity (Blyth 2013; also Eichengreen 2015, and Paul Krugman's New York Times columns 2014-2016). Neo-Keynesians singled out Germany for its unwillingness to do this, disagreed with the European Commission's neoliberal analyses, and would have liked the ECB to have done more. Whether such policies would have worked is unknowable because they were not tried, but they would have had to find ways to avoid moral hazard and to ensure that needed reforms were made at the national level, both difficult matters. There was also extensive support, particularly from France and Italy, for "mutualising" the costs of crisis-fighting through financial instruments such as "Eurobonds" that Germany and other northerners refused. Finally, there was persistent, if vague, discussion about the negative political effects of "austrian" approaches that advocated greater EMU and EU democratization and, often, more federalism.

### **Crisis Policies, Institutions, and the EU's legitimacy**

Eurozone crisis decisions have been made in the Euro-group (19 EMU members) and the European Council (28 EU members) working inter-governmentally. This kind of multilateral bargaining is known to be slow, prone to suboptimal results, and often dominated by its stronger participants, and all of these things have been true since 2009. Eurozone crisis bargaining has also led to serious mistakes. The six months that it took to decide after the 2009 Greek announcements inflamed markets, making the crisis worse. Interest rates on the first Greek loan were too high, leading markets to anticipate Greek insolvency and making new loans to Greece (three to date) inevitable. A German proposal in 2011-2012 to make bank shareholders, as opposed to taxpayer-funded bailouts, partially accountable for crisis losses created new market panic that ended only after Draghi's "do what it takes" speech. The 2012 German- and French-engineered dismissal of the Greek and Italian Prime Ministers (Papandreou had proposed a referendum about crisis policies, Berlusconi had been evasive on Italian reforms) and their replacement by technocrats fuelled anti-EU fervour in subsequent elections. The effects of austerity policies then helped push Europe into a second recession in 2012-2013.

Crisis policies have sapped public support for the EU, and not only in countries obliged to austerity. The autumn 2013 *Eurobarometer* showed a 25% drop in positive, and a 15-point rise in negative, opinions of the EU after 2006-2007, leaving both sides neck and neck at 30% (OECD 2014). Oddly enough, surveys also reported that majorities believed the Euro to be a good thing (EC Eurobarometer 2015). Incumbent governments seen as responsible for harsh policies have been repeatedly voted out. Crisis events and policies

have also enhanced the positions of populist newcomers right and left and magnified Euroscepticism.

## **Results**

We cannot say much about the ultimate effectiveness of crisis policies because it takes a very long time to recover from an economic disaster as large that in the Eurozone. The European Commission's ECFIN General Directorate conclusion that "the euro area's recovery remains subdued and fragile" provides a useful summary, however (European Commission 2015, 316; see also OECD 2015). Economic growth in the EU has returned – just barely in most, but not all, countries, hovering around 1% annually. EU unemployment has peaked and begun declining slightly (from 12% to 10.5%), but youth unemployment remains much higher, especially for the worst-hit countries. Investment is weak, productivity growth is stuck, and public debt remains high. Much of this can be tied to austerity policies, although some also flows from the flaccid state of the global economy. Whether crisis policies will set the Eurozone towards needed new convergence is unknown. On a political plane, crisis policies have created greater legitimacy problems for the EU, but only a crystal ball could tell us how they will play out in the future. "Populist" political forces on the right and left have disrupted traditional national electoral shifts between centre-lefts and centre-rights. If it has been legal in EU treaty terms for the Euro-group and European Council to respond to crisis by following German and northern policy preferences, this has been seen by many Europeans as the imposition of "their" positions on "our" lives. In addition, most of the new approaches to Eurozone economic governance involve large increases in the regulatory roles of the European Commission in ways that may lead to even more discontent about the "Brussels bureaucracy." Such trends could continue and could also combine with the harsh disagreements emerging around the refugee issue, the Brexit referendum, and the development of "illiberal democracy" in some new member states. The EU's storms may not be over.

It is hard to see the relevance for Canada of the EU's Eurozone crisis policies, except, perhaps, for those with a fondness for austerity as a method of purifying institutions and individual behaviours. Canada's effective banking regulations, central bank, and limits on provincial budgetary practices weathered the post-Lehman Brothers moment well and avoided the confluence of policy approaches and institutional arrangements that fed the Eurozone mess. Nothing guarantees that Canada will avoid major economic difficulties in the future, of course, at which point it may be that policy debates might – vaguely – resemble those heard in Europe between "Austerians" and "neo-Keynesians." Canada is a federal state, however, and not an intergovernmental arrangement in which more powerful national actors can impose their wills on others. This is a huge difference. What has happened in the Eurozone crisis should nonetheless provide guidance about what policies to avoid.

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