The Re-emergence of Europe

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The Re-emergence of Europe
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Europe has reached a critical tipping point. It faces either disintegration and collapse or a chance to achieve deeper integration and emerge much stronger from the current crisis. For the moment, the European project of integration is halted midstream: between the old collection of nation-states and full European political union. In the years to come, a multitude of scenarios and variations ranging from a disorderly collapse to a flamboyant “resurrection” are possible, many of which, with hindsight, will surprise us – possibly on the upside.

Even in the worst-case scenario, a “Europe” and institutions referred to as the “European Union” will remain. My own prudent prediction for Europe is that it will manage through the turmoil, with the euro intact, even if one or even two countries were to leave the eurozone. Based on the analysis laid out in this book, my firm and optimistic belief is that, once the crisis subsides, which may take up to a decade, Europe will regain its momentum, propelled by a renewed sense of mission among politicians and policy-makers to keep this decades-long project on track and moving forward.

Despite the current uncertainty, two things remain beyond doubt: (1) this problem has no quick fix or easy solution, and (2) as the world’s largest economy by gross domestic product (GDP), whatever happens to the eurozone matters enormously to the rest of the world. Thus the European crisis will, to a greater or lesser extent, dominate global issues for many years to come.¹

Within Europe, opinion-shapers and policy-makers are deeply divided about the future of the continent, but outside Europe – in the United States and Asia in particular – the general consensus is that the euro will collapse and that Europe will “disintegrate”, although what this means remains vague. Those who embrace these predictions are generally unaware of how the euro came to be created and the reasons why the currency was devised. Among the media in particular, there is a streak of pessimism that is based on a lack of information and appreciation of history, as well as a troubling fixation with the sensational and the deepest downside of this unfortunate situation.

I hope that this short book provides the necessary context to remedy this lack of understanding. The Re-emergence of Europe has two main objectives: (1) to explain in simple terms what is currently unfolding in Europe and what is at stake, and (2) to review and assess certain policy options under consideration to resolve the crisis. Many of these policy options are based upon projects and initiatives pursued at the World Economic Forum, of which I am the founder.
and executive chairman. Most – but certainly not all – were discussed and debated in recent Forum gatherings.

To a large extent, this book also relies on private and public conversations I have had the privilege to enjoy over the years with key policy-makers and experts, as well as with business and civil society leaders. Many of these thoughts and ideas have contributed to shaping the Europe we know today and will play their part in framing the Europe of tomorrow.

This book takes a multifaceted and multidimensional approach, which runs counter to the currently fashionable siloed approach (looking only at economics while disregarding politics, for example). I adopt a holistic perspective combining economics, sociology, international affairs and history, and even an ethical dimension, for two reasons:

– Since its onset in 2009, the eurozone crisis has undergone several mutations. What started as a financial crisis caused by sovereign indebtedness in Greece rapidly spread to other countries, accumulating multiple layers of additional predicaments along the way. Now the entire European continent faces financial, economic, banking, political, institutional, societal and moral crises. Because they are so intertwined, these many different predicaments pose exceedingly complex challenges that simultaneously require strong political leadership, original policy proposals and solutions, and a set of institutional changes. In light of all the above, it is hard to disagree with the notion that the eurozone is unique in recent history, both in terms of its depth and complexity. It is also unique in terms of its size as a monetary union, as it requires constant coordination on the part of the 17 disparate eurozone countries. More often than not, the negotiations have to involve all 27 EU member states – the more parties to the negotiations, the greater the complexity!

– None of the plethora of ideas currently under discussion to resolve Europe’s problem, in my opinion, can sensibly be considered if viewed in isolation from the broader perspective of what is doable or not. This point is best illustrated by some examples. Several opinion columns in the international media have suggested that Greece should sell some of its islands to certain foreign buyers as a means to reduce its sovereign debt. Such a proposal may make sense economically, but it does not from a political and societal perspective: it would simply be a violation of Greek sovereignty. As such, it is of no use for the purposes of this book. Others have proposed that the EU should implement as rapidly as possibly a constitution modelled on that of the US with full fiscal transfers. Economically, it makes a lot of sense. Politically and institutionally, that suggestion is a non-starter within a reasonable time frame. Inversely, some ideas are politically appealing but economically unrealistic. That private creditors, rather than the taxpayers in creditor countries, should solely bear the risk of default is one such proposal.
It seduces politicians but worries economists and market participants because of the mayhem that would ensue in the financial sector and the disincentive that it would create for future lending. In this book, I review, analyse and put forward only measures and policies that are implementable from a policy-making as well as social perspective, even if the ideas are not easy to apply.

In terms of how policy-makers, regulators and business leaders deal with Europe’s predicament on a daily basis, it is critical to understand that they are doing so against the background of a world in flux. Our world is changing very fast, ubiquitously and in a profound manner. In Europe and elsewhere these days, the words most frequently heard are “uncertainty”, “fragility”, “volatility”, “turbulence”, “unpredictability”, and such. Four growing forces – interdependency, complexity, velocity and transparency – are at play, creating a global landscape that only a decade ago was the province of futurists. These four forces constantly interact and mutually reinforce each other, making the world, and of course Europe, much more susceptible to shocks and surprises than just a few years ago.

The global environment now seems to be, as Thierry Malleret describes it in his book *Disequilibrium: A World Out of Kilter*, “on the verge of constant instability, with ‘random’ occurrences happening all the time. As the world becomes a conveyor belt for constant surprises, leaders have the impression they are driving at very high speeds in the fog, unable to find the brakes, lurching from one crisis to the next”. This is seemingly often the case for European leaders who, like most of their peers, find themselves increasingly wrong-footed as they contend with situations that frequently take them by surprise.

This state of affairs not only alters their understanding of the world but affects the way they exercise leadership, and it can even create feelings of burn-out. In my experience, it is fair to say that to lead has never been so hard or challenging. Although this may sound trite, it must be kept in mind when thinking about the way European policy-makers are dealing with a very difficult situation.

I am well aware that addressing such a broad and sensitive topic at the very time the crisis is unfolding and policy proposals are being put forward is a herculean task. Hundreds of articles, editorials, discussion fora and conferences are continually debating what ought to be done with respect to Europe and the eurozone. Every day, dozens and dozens of pundits and politicians argue over the specifics of implementing (or rejecting) particular policies and proposals.

My objective is different: I would like this book to serve as an easy reference for all those who have an interest in the fate of Europe and in European affairs. I trust the multidimensional approach adopted in this book will help them better understand Europe’s intricacies and where they are likely to lead. *The Re-emergence of Europe* is short and simple (but not simplistic) and well informed.
Much of its content derives from my deep interest in Europe. While the World Economic Forum is today a truly global organization, integrating leaders from all walks of life, its origin goes back to the fact that I spent my childhood in Germany during and after World War II. I belong to the first generation of Europeans for whom Europe has not only an economic but also a deeply political meaning. This book also draws from situations in which the World Economic Forum has played the role of “honest broker” or “trusted adviser” when discussing and evaluating policy proposals and putting forward new ideas as part of the various initiatives it pursues and during its events, such as the Annual Meeting in Davos-Klosters.

I would like to thank Thierry Malleret, who was an essential partner in researching and writing this book. I drew substantially from World Economic Forum research and internal documents and am grateful to Jennifer Blanke, the Forum’s chief economist, particularly for her contribution related to Europe’s competitiveness. Special thanks also to Fabienne Stassen, who in record time edited this book, as well as to Kamal Kimaoui, who as usual made sure that the contents are presented in the best graphical way. Thanks also to Melanie Rogers and Al Reyes and Adrian Monck as well as to my two assistants, Nancy Knowlton Méan and Jeanine Meili, who had to carry out this additional work during a time when the Forum and I were involved in so many different activities, trying to improve the state of the world.

This book is structured in two main blocks: Decline and Re-emergence. The chapter on Decline details how Europe came to be in the mess it is in. The chapter on Re-emergence discusses some of the options that will put Europe on a much stronger path. The experience of watching economies emerge over the past forty years gives me both confidence and optimism that Europe’s economy can re-emerge stronger and more sustainable.

Needless to say, this volume deals with a very fast-moving and fluid situation. This explains its publication in the form of an e-book, reflecting the volatile and ever-changing nature of the subject matter. Its contents will be continuously updated based on the direction of the policy debate and what actually takes place on the ground.
2. A SHORT HISTORY OF EUROPE

Many conversations and propositions about Europe fail to convince because of their lack of historical perspective. Indeed, the present and future cannot be understood without a modicum of history, which, in the words of the French poet and politician Alphonse de Lamartine, “teaches us everything, including the future”.\(^3\) As is the case for most other continents, Europe’s history not only reveals the rich diversity of its past but, perhaps more importantly, the many different prisms through which the current situation and some of its possible outcomes can be understood. It is therefore natural to start this book with a panoramic overview of European history, alongside a snapshot of how the European Union (EU) and the euro came into existence.

For all the claims that Europe has existed since antiquity and that it embeds the notion of democracy, it is essential to remember that many European nations have been united and democratic only in recent years. Italy unified in 1870, while Spain experienced a civil war less than a hundred years ago. Greece, Spain and Portugal were dictatorships well into the mid-1970s. For much of its history, rather than a neat collection of Westphalian sovereign states with clear national borders that co-exist in peace, Europe has been a jumble of rival countries, territories and enclaves linked by languages and culture but fragmented by tribe and tribal allegiances.\(^4\)

The idea of Europe is relatively modern, having emerged in a complex intellectual and political process spanning the 14th and 18th centuries. During that period, the earlier concept of “Christendom” was gradually replaced; it was only after the Treaty of Utrecht in 1713 that the awareness of a European rather than a Christian community began to prevail. The last reference to the *Respublica Christiana* – a Christian Commonwealth – dates back to this time. In 1751, the French writer and philosopher Voltaire described the Christian part of Europe, with Russia excepted, as “a great republic divided into several states, some of which were monarchial, others mixed, some aristocratic, and others popular; but all corresponding with one another; all having the same basis of religion, though divided into several sects, and acknowledging the same principles of public and political equity, which were unknown to the other parts of the world.”\(^5\) In the eyes of many historians, the final realization of the idea of Europe came at the end of the 18th century. In 1796, the Irish political philosopher Edmund Burke famously declared that, “no citizen of Europe could be altogether an exile in any part of it.”\(^6\)
Throughout history, Europe experienced a sequence of cultural and political integration. As Nobel Economics Prize laureate Amartya Sen has pointed out,7 the first public call for more European integration dates as far back as the 15th century when the idea of pan-European unity was originally mentioned. In 1713, French priest Charles-Irénée Castel, abbé de Saint-Pierre, wrote a book entitled *A Project For A Perpetual Peace*, in which he advocated a confederation of European powers destined to guarantee lasting peace on the continent. Other pleas followed from many prominent names, including political figures from abroad. In the 18th century, for example, George Washington is believed to have written in a letter to the Marquis de Lafayette that a United States of Europe would one day be established, with the United States of America as the model.

These bold ideas were insightful for their time, but it was only in the 20th century, with two World Wars and the incredible devastation they inflicted on the continent, that the need for political unity was spurred.

To this day, the possibility of a war in Europe is feared by many of my generation. Only in this context is it possible to understand the movement for the unification of Europe, which aimed for political unity. Neither a common currency nor financial union were objectives. The single most important driving force of European integration by far was the memory of war, powered by the idea that such conflict should never again happen. This is what prompted Winston Churchill to declare in a famous speech in Zurich just after the war: “We must build a kind of United States of Europe”.8

Today, few among the young generations realize that World War I caused 37 million casualties among the military and civilian populations of Europe (more than 16 million died and more than 20 million were wounded). World War II was even worse. In Europe itself, 55 million people died (20 million in the Soviet Union). Europe was not built for economic or financial reasons but, after such prolonged devastation, to bring peace between European countries. It was a political ambition, whose design was essentially a Franco-German compromise.9

In 1950, only six years after German troops had left Paris and at a time of mutual hatred and suspicion between France and Germany, Robert Schuman, then French minister of foreign affairs, assisted by Jean Monnet, one his counsellors, announced a plan to create the European Coal and Steel Community (ECSC), with the aim of making war “not merely unthinkable, but materially impossible”.10 Schuman’s core idea was to place French and German coal and steel production under a single authority to prevent the two sides from using the raw materials of war against each other (and also, of course, to power a common industrial economy).

Today, a military conflict in the EU is indeed hard to imagine, as unlikely as a clash between other democratic trading nations such as Canada and the Unit-
ed States or Australia and New Zealand. This is a tribute not only to the various European institutions that led to further integration but also to other organizations such as the North Atlantic Treaty Organization (NATO) that played such a crucial role in cementing peace on the European continent. Both NATO and the European Community (EC) originated in post-World War II efforts to bring stability to Europe. NATO was created to ensure security for the United States and its European allies to counter the Soviet Union.

The ECSC was in effect the institution that gave birth to today’s European Union. These fundamental steps to establish long-lasting peace have been recognized with the awarding of the Nobel Peace Prize in 2012 to the EU. According to the Norwegian Nobel Committee, the work of the EU represents “fraternity between nations” and amounts to a form of the “peace congresses” to which Alfred Nobel referred as one of the criteria for the Peace Prize in his 1895 will.\(^\text{11}\) The Committee explicitly praised the EU for helping turn Europe “from a continent of war to a continent of peace”.\(^\text{12}\)

As the Hungarian-American financier George Soros has written,\(^\text{13}\) European integration was driven by a group of visionary statesmen: not just Monnet and Schuman but Konrad Adenauer and Paul-Henri Spaak, among others. Although the founding treaties spoke of an “ever closer union”, they understood that perfection was unachievable. Therefore, they set themselves limited goals and rigid schedules, then rallied the political will needed to achieve what could be done, fully understanding that, when that was achieved, it would eventually become obvious that the status quo would be untenable and further steps would have to be taken. That is how the ECSC, founded in 1951, was gradually transformed into the European Union, attaining critical milestones such as the European Economic Community (EEC) that eventually led to the creation of a single European market.

Essentially, these leaders with a vision practised what philosopher Karl Popper called “piecemeal social engineering;”\(^\text{14}\) every step of European integration was the result of the development of common European policies in various fields, including agriculture, fisheries, trade and eventually monetary affairs. There was, and still is, a caveat, though: the democratic politics of the European Union have always remained quintessentially national, leading to what is now commonly referred to as the “EU democratic deficit”. I shall return to this important point later in the book.

From the very beginning, France and Germany led the effort towards European integration, although there were initially six states and subsequently three others involved. The six founding nations (Belgium, France, West Germany, Italy, Luxembourg and the Netherlands) signed the Treaty of Paris that established the Coal and Steel Community in April 1951. In 1957, they went further and signed the EEC Treaty in Rome, whose aim was to foster economic integration (including a common market). Three others – Denmark, Ireland and the United
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Kingdom – joined in 1972. All of them embraced the ideals of democracy and freedom, and subscribed to the rule of law. No country dominated. Even though the bureaucracy in Brussels was often accused of nurturing a “democratic deficit”, all major steps had to be approved by elected parliaments.

When the Soviet empire disintegrated, German leaders understood that reunification would only be possible in the framework of a more united Europe. They knew it would not be easy, echoing the often quoted words of the writer Thomas Mann, who proclaimed in 1953 that he wanted “not a German Europe but a European Germany”. When negotiating, the Germans were disposed to compromise, which made finding agreement easier. Indeed, the German politicians would state that Germany had no independent foreign policy, only a European one. Hans-Dietrich Genscher, when he was West German foreign minister, famously said: “The more European our foreign policy is, the more national it is.”

This approach helped the process enormously, both in size and further integration. In terms of size, the first steps taken were to overcome once and for all Europe’s post-World War division by including most countries of Central and Eastern Europe. Simultaneously, economic integration was furthered, culminating with the signing of the Maastricht Treaty in 1992, the launch of the euro in 1999 and the currency’s circulation in 2002.

It is essential to remember that this process took place against the background of constant currency instability, from the introduction of floating rates in the early 1970s to the euro’s creation. A number of endeavours to fix one European currency against another collapsed due to the different economic performances of the countries concerned. Such was the case, in particular, with the forced withdrawal of the pound sterling from the Exchange Rate Mechanism (ERM) in 1992.

The EU today comprises 27 countries, of which 17 have committed to the euro. There are five candidate countries for accession: Croatia, Iceland, the Former Yugoslav Republic of Macedonia, Serbia and Turkey. With the crisis now engulfing the entire European Union, particularly the eurozone, all understand that the Maastricht Treaty was imperfect in its design. Also, critical components, such as a common social policy, were missing.

The Treaty established a monetary union without the political union that constitutes a prerequisite for a common currency to function properly. How could that be? The founders of the euro and other people involved in its creation themselves recognized that it was an imperfect structure. There was a central bank but no common treasury that could issue bonds that would be endorsed by all the member states. They all believed, however, that when the need arose, so too would the motivation necessary for a political union. That never happened. As a result, “the eurozone now rests on the shaky basis of a confed-
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generation of states that are committed both to a monetary union and to retaining their fiscal sovereignty,” former German foreign minister Joschka Fischer wrote last year. “At a time of crisis, that cannot work.”

Unfortunately, the euro had many other defects, of which neither the architects nor the member states were fully aware. For several years, Germany and most northern European countries adhered to fiscal discipline and maintained moderate levels of debt, while most southern economies went on a spending spree. Either public spending, like in Greece, or private spending, like in Spain and Ireland, skyrocketed. The financial crisis of 2007-08 revealed these excesses and the imbalances that had built up within the eurozone, setting in motion a process of potential disintegration. Slightly more than 10 years after its creation, the financial markets began battering the euro. Many hedge funds bet that the single currency would not survive, thinking – wrongly – that the euro is nothing more than a technical creation that could disappear without causing too much trouble. The euro is much more than that. Politically, it holds important symbolic value throughout Europe. In Germany, the euro is perceived as the symbol and tool that commit the country to a united Europe.

Today, the European Union is in the throes of an existential crisis threatening its very survival. The turmoil in the eurozone crisis has resulted in a situation in which economic and political considerations are completely intertwined. So much so that they are now generating an adverse feedback loop: a bad economic situation makes politics divisive, which in turn exacerbates the economic and financial problems.

Yet, amid the crisis, it is important to recall Europe’s impressive track record. As documented by the Global Agenda Council on Europe of the World Economic Forum, a great deal has been achieved over the past few decades. Generally, the integration of European countries has been a great success, leading to the creation of a single market of 500 million consumers. The single market, launched in 1992, has been one of the greatest achievements of the European integration process, transforming the way in which citizens live, work, travel, do business and even study. Most importantly, from a trade perspective, European enterprises can do what was previously inconceivable: sell their goods and services across borders without incurring specific taxes or facing other obstacles.

First and foremost, wars in Europe have become a thing of the past, with the exception of some countries in the Balkans that were not members of the European Union. Economically, Europe is also a great success story, despite dramatic divergences in performance that are analysed in depth in this book. In 2011, according to the International Monetary Fund (IMF), the combined GDP in nominal terms of the 27 EU member states amounted to US$ 17.6 trillion, higher than that of the US (US$ 15.1 trillion) and China (US$ 7.3 trillion).
With 20% of world trade, the EU is the world’s second largest exporter and importer, after China and the US, respectively. Europe’s labour productivity is one of the highest in the world.\textsuperscript{19} On average, Europeans are considered to have the best quality of life. Indeed, high levels of economic activity mesh with equity and social inclusion much better than in most other countries, prompting some commentators to call Europe the “lifestyle superpower”. The United Nations Development Programme Human Development Index ranks 13 European countries in its list of the top 20 performers.

Put simply, the European Union has been an amazing success story, especially when considering the ashes from which it arose. A united Europe brought more competition and therefore more prosperity to the entire continent. Brussels opened protected markets and broke up state monopolies in transport, telecommunications, energy and other sectors. Guy Sorman, a liberal economist, describes the European Commission, an institution that is so often derided, as “the major free-market agent we have in Europe”\textsuperscript{20}.

The euro, meanwhile, brought currency stability but most importantly it took the tool of devaluation away from politicians who wanted an easy fix and refused to implement structural reforms. It forced each economy to be more flexible and more productive because it was much easier to implement free-market principles than when decisions belonged to each nation. In addition, EU enlargement has been the key factor in helping ensure the remarkably successful transition of former communist countries to full-fledged democracies and market economies.

Even at the micro level, Europe has thrived. European multinationals are just one example. They have been very successful, investing abroad far more and in more countries, particularly emerging markets, than their American and Japanese counterparts.\textsuperscript{21}

Without anticipating what follows in the coming chapters, it is important to note that the crisis has already generated quick solutions to obvious shortcomings. Greece’s political leaders will no longer be able to falsify the budget as they did for years. Italy and Spain have proposed tangible solutions to clean up their banking systems and reduce their debt and fiscal imbalances. The EU authorities’ power to monitor and enforce budget ceilings has been significantly strengthened, making it unlikely that France and Germany’s mistake of breaching the EU treaty’s limits on fiscal deficit without consequence a decade ago (encouraging bad fiscal behaviour by others in the process) will be repeated. The EU’s enforcement powers have strengthened sufficiently to prevent it.

In the years ahead, if and when a revitalized EU lessens regulatory, tax and other burdens on the private economy while maintaining a certain degree of social protection, the stage will be set for the exploitation of great entrepreneurial energy.
It is also important to look at what has been avoided on the downside. Despite all the negativity about Europe, one phenomenal success has already been achieved in the midst of the crisis: the euro has acted as a powerful bulwark against the temptation to engage in protectionism and competitive devaluations as prevailed during most of European history and globally in the 1930s.

KEY POINTS
– The idea of Europe is relatively modern (end of the 18th century)
– The memory of World War II constitutes the most important driving force of European integration
– France and Germany led the process of integration
– The Maastricht Treaty was flawed and its European architects knew it
– Today, the eurozone crisis is generating an adverse feedback loop between politics and economics
– Overall the EU is an amazing success story
3. DECLINE

From the outset of the idea of a common currency, such prominent economists as Milton Friedman and Martin Feldstein proclaimed the end of the euro, warning that, since the eurozone was not an "optimal currency area", the single currency could only fail. A number of factors were given, including labour market rigidities, the lack of redistribution mechanisms and the strong national identities of the members. On the other side, Robert Mundell, one economist who had argued strongly for the euro’s creation, believed that with the free movement of capital and trade, closer political union would come and the eurozone could evolve into a natural optimal currency area.

Today, proponents of European integration recognize all the problems underlined in the period leading up to the euro but argue that its creation was essentially a triumph of politics over economics. They claim that the economic logic underestimated the political will that has driven European monetary union since its inception. Now that it is being shaken and mercilessly tested by the financial markets, facts seem to vindicate the position of the early sceptics. For Feldstein, failure is inevitable and far-reaching; the progressive disappearance of the eurozone is the chronicle of a death foretold:

The euro should now be recognized as an experiment that failed. This failure, which has come after just over a dozen years since the euro was introduced, in 1999, was not an accident or the result of bureaucratic mismanagement but rather the inevitable consequence of imposing a single currency on a very heterogeneous group of countries. The adverse economic consequences of the euro include the sovereign debt crises in several European countries, the fragile condition of major European banks, high levels of unemployment across the eurozone, and the large trade deficits that now plague most eurozone countries.

The political goal of creating a harmonious Europe has also failed. France and Germany have dictated painful austerity measures in Greece and Italy as a condition of their financial help, and Paris and Berlin have clashed over the role of the European Central Bank and over how the burden of financial assistance will be shared.

Many do not share such an extreme position. However, most agree that, for a while, the existence of a single currency allowed the fundamental economic imbalances within Europe to be hidden. Because of the crisis, this concealment has come to an end.
3.1. The Debt Overhang

In the early years of the euro, interest rates fell across the board thanks to the robust anti-inflationary stance of the European Central Bank (ECB), including in countries such as Italy and Spain where expectations of high inflation had previously kept interest rates elevated. “Blessed” with such a situation, households and governments in these countries responded by increasing their borrowing; they went, in the words of the historian Timothy Garton Ash, “on the mother of all binges”. From 2000 to 2008, government expenditure as a proportion of real GDP increased on average by 12 percentage points in Ireland and by 3.8 points in Greece, Italy, Portugal and Spain. As the economist Allan Meltzer said in an interview with Fortune magazine: “It doesn’t help when the government is used to borrowing at 12% and suddenly it can borrow at 3% or 4%.”

Households used their increasing debts to finance a surge in home construction and a concomitant increase in housing prices. The governments used them to fund larger welfare programmes. This resulted in rapidly rising ratios of public and/or private debt to GDP in southern Europe and Ireland. In some countries like Greece, the public debt skyrocketed, while in others like Spain and Ireland, it was private debt that exploded.

In normal conditions, the debt markets should have responded by raising interest rates on those countries; they did not because they made the assumption – a wrong one, it turned out with hindsight – that a bond issued by any member state was as safe as that of any other European Union nation. They disregarded in the process the provision included in the Maastricht Treaty that prohibited a financial bailout of any member state by another. In consequence, the interest rates on Italian and Greek bonds differed from the rate on German bonds by only a few basis points. Contrary to the situation that prevails when a monetary union does not exist (where fiscal deficits lead to higher interest rates or lower exchange rates, acting as a warning for countries to reduce their borrowing), countries continued to borrow excessively and banks continued to lend excessively to buyers of housing that was overpriced. Only at the end of 2009 did the financial markets recognize their mistake of considering all eurozone countries as equally safe. Very soon afterwards, the interest rates on the sovereign debts of Greece, Italy and Spain started to diverge from the others.

Market dynamics put into motion an adverse feedback loop: rising interest rates soon became unsustainable and led countries to the brink of insolvency. What was originally a liquidity problem rapidly became a solvency issue. Very quickly, expectations of higher future interest payments implied a “doom loop”, meaning that, as debt burdens grew faster than originally thought, they would in turn lead the financial markets to require even higher interest rates to contin-
ue financing these countries, thereby increasing the future stock of debt even further.

As shown in Figures 1 and 2, the government deficit as a share of GDP is much lower in the eurozone than in the US, the UK and Japan. The gross government debt is roughly similar to that of the US and the UK, and much lower than in Japan. Yet it is the eurozone that is currently in the line of fire. Why? Because the eurozone is not one country. The reason the financial markets’ anxiety is currently focused on the eurozone is because when the picture is disaggregated, it looks very different. It does not look as good as it appears in the charts with, very roughly, a partition between the North, mainly composed of surplus countries with reasonable fiscal positions, and the South, mainly composed of deficit countries with “shaky” – if not unsustainable – fiscal positions. (Ireland is the exception.)

The current crisis has laid bare the divergent economic circumstances, productivity and income levels differentiating the north from the south of Europe. With hindsight, the initial conversion rates to the euro were probably too high for the southern countries, enticing them to consume too much (as the high exchange rate conversion increased the purchasing power of private savings) and produce too little (as unit labour costs became too high, although this is only part of the picture).

Figure 1: Government Deficit, 2012 and 2013 (% of GDP)
**Figure 2: Gross Government Debt, 2012 and 2013 (% of GDP)**

![Gross government debt (% of GDP)](#)

Source: Absolute Strategy Research: IMF, Thomson Reuters Datastream

**Figure 3: Deficit and Debt by Eurozone Country (% of GDP)**

![Fiscal balance (% of GDP)](#)

Source: International Monetary Fund, World Economic Outlook Database (October 2012 edition).
In a paper delivered at the famous Jackson Hole Economic Policy Symposium in 2011, three economists from the Bank of International Settlements (BIS), often referred to as the central bank of central banks, reported that they used a new dataset that includes not only government debt but also non-financial corporate and household debts to determine when good debt goes bad.26 Their conclusions: debt becomes a drag on growth when it exceeds levels of about 85% of GDP for government debt, 90% of GDP for corporate debt and 85% of GDP for household debt.

In the eurozone, but not in the UK, the debt overhang concerns mostly the public sector. As the two charts below demonstrate, both household and corporate debt remain below or just at the levels that should raise concern.
Figure 4: Household Debt, 1990-2014 (% of GDP)


Figure 5: Corporate Debt, 1990-2014 (% of GDP)

3.2. The Banking Crisis and Its Collateral Effects

When the euro was introduced, all government bonds across the eurozone were treated in a similar fashion: as essentially without risk. Accordingly, regulators across the eurozone permitted banks to purchase any number of sovereign bonds. They did not require them to put aside any equity capital, which meant that the ECB made no distinction between the bonds of different member governments. Therefore, commercial banks found it interesting to buy the bonds of the weaker member states because they could earn some extra basis points on slightly higher interest rates.

Only at the end of 2009 did the financial markets begin to realize that the government bonds of weaker eurozone countries carried significant risks and could possibly even default. This happened after the newly elected Greek government announced that the country deficit exceeded 12% of GDP. Immediately, risk premiums – the extra yield that governments must offer to be able to sell their bonds on the markets – rose dramatically.

This phenomenon created a banking problem over and above the debt issue, by rendering commercial banks potentially insolvent as their balance sheets were loaded with these poor quality bonds. As Table 1 shows, a few “systemically important” banks have high exposure to toxic sovereign assets, most notably in Italy and Spain. This matters to the system as a whole because the banking system is highly interconnected. As such, it is hard to imagine how the failure of just one bank would not propagate stress through the entire system.
This makes it very apparent that the banking and sovereign crises are completely intertwined, linked in a reflexive feedback loop. In the words of George Soros, “they are tied together like Siamese twins and cannot be solved separately.” Not all eurozone crises are equal in nature, however. In Ireland and Spain, for example, the crisis results from excess private-sector demand that led to a real estate bubble and eventually to a banking crisis. This, not fiscal profligacy as in the case of Greece, was the major cause of the crisis. Economic and political pressures forced governments to bail out their banks, significantly increasing public debt, which in turn led the sustainability of government finances to be questioned.
Despite the rollover of debt from banks to public institutions, European banks are still substantially over-exposed compared to the US and Japan (as the figures from 2010 show in Table 2). This also explains the pervasive nervousness of the international investment community, as related to the European crisis.

### Table 2: Size of the EU-27, US and Japanese banking sectors (2010)

<table>
<thead>
<tr>
<th></th>
<th>EU</th>
<th>USA</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets of banks (€ trillion)</td>
<td>42.92</td>
<td>8.56</td>
<td>7.15</td>
</tr>
<tr>
<td>Bank assets, % of GDP</td>
<td>349%</td>
<td>78%</td>
<td>174%</td>
</tr>
<tr>
<td>Assets per bank of the top 10 banks (6 for Japan) (€ billion)</td>
<td>1,501</td>
<td>480</td>
<td>625</td>
</tr>
<tr>
<td>Top 10 banks’ assets (6 for Japan), % of GDP</td>
<td>122%</td>
<td>44%</td>
<td>91%</td>
</tr>
</tbody>
</table>

Note: The Asian crisis figure includes Indonesia, South Korea, the Philippines and Thailand. Source: Monthly Barometer. www.monthlybarometer.com

The end result is that banks in the eurozone badly need to strengthen their balance sheets, mainly by revisiting their portfolios to take into account further capital needs that can cover risky sovereign debt. Much of the European banking system, particularly in southern Europe, will have to go through a painful phase of consolidation and restructuring that goes beyond sovereign debt. The Spanish banking system epitomizes this situation. Most of its banks have recently posted sharp falls in profits after having been forced into write-downs to cover heavy losses on their real estate assets and loan portfolios.

In August 2011, Christine Lagarde, the managing director of the IMF, initially warned about the inadequate capital levels in European banks. She then referred to internal research showing that, if European banks were stress-tested for the sovereign default risks implied by the financial markets, they would be short of capital by 200 to 300 billion euros. In aggregate, very little has been done. Meanwhile, a slow-motion run on the banks in southern Europe, particularly Greece and Spain, has beset the banking system for more than two years. Why are the depositors concerned? Simply because of the perception that one euro in a Greek bank no longer equals one euro in a German bank. (If Greece were to exit the eurozone, it would immediately implement a freeze in deposits and euros would be converted into depreciated drachmas.)

This problem of capital outflows and of banks’ unhealthy balance sheets is paradoxically exacerbated by the policies being undertaken to support national banks. Banks in every eurozone country mostly hold bonds issued by their “host” country. As concerns grow over the sustainability of public finances in
some countries such as Greece and Spain, the value of their sovereign bonds falls. This creates a “hole” in the assets of the banks holding their bonds. As governments step in to fill these holes with public funding, their debt increases and the sustainability of their finances deteriorates even further. This, in turn, decreases the value of their bonds, feeding an adverse loop that creates new holes in banks’ assets.

Several prominent academics have emphasized the fact that Europe’s financial system relied to a large extent on moral hazard. Indeed, the “no defaults” policy put forward by the European authorities at the outset of the crisis has enabled banks to attract the funding needed to roll over large amounts of short-term bank and sovereign debt.

The problem is that creditors lent money to banks and the sovereign under the assumption that they would all be fully supported during periods of trouble, which may not be the case anymore. Due to weak public finances, some sovereigns may find it impossible to bail out their banks at the same time the more robust eurozone members display increasing hesitancy to bail them out. That is why the euro area is now switching from a moral hazard regime to new arrangements under which all nations must fend for themselves only in principle. In particular, politicians in creditor nations have called for private-sector burden sharing, leading investors to demand even higher interest rates for holding these debts, with the possible perverse effect of higher rates tipping banks and nations towards bankruptcy.

Also, in past months, national regulators have favoured domestic lending. Meanwhile banks have shed assets outside of their country of origin. They did so hoping that a possible break-up or exit by one country could occur without triggering a complete meltdown of the financial system. The words “in principle” mentioned above are important because, although the financial system in the eurozone has been progressively reoriented along national lines, a break-up would leave creditor countries (primarily Germany) with claims against the central banks of the debtor countries that are substantial and also hard to collect.

The reason for this has to be found in the eurozone clearing system called TARGET2, a settlement system for all payments involving the eurosystem, which is itself the central banking system of the euro area. TARGET2, in contrast to the clearing system of the US central banking system, the Federal Reserve, which is settled annually, accumulates the imbalances between the banks within the eurozone indefinitely.

This should not be a problem when the interbank system functions well: the banks simply settle their respective imbalances through the interbank market. When the interbank market does not function well (which has been the case since the summer of 2011), an increase in capital flight occurs in the weaker
countries. How does this work? If a Greek depositor makes a transfer from his account in Greece to a German financial institution, the German Bundesbank will end up with a TARGET2 credit, which is offset by a TARGET2 claim against the Greek central bank. Since the onset of the crisis, claims within the TARGET2 system have grown exponentially. By the summer of 2012, the Bundesbank had accumulated claims of more than 700 billion euros against the central banks of southern European countries.

Germany’s mounting net claims within the European central banking system do not necessarily mean that it would lose much if the eurozone were to fall apart. The reason is that Germany, like other surplus countries, has accrued net claims not because of internal central bank reckoning but because it has built up a substantial current-account surplus, resulting from the export of goods and the import of financial claims.

As a recent academic paper demonstrates, balances within TARGET2 are not a good indicator of this new financial risk because they have only risen due to speculative financial flows. These, by nature, do not affect net cross-border claims. To put it in slightly simpler terms, TARGET2 losses would accumulate on the books of the ECB. Therefore, Germany would only lose the amount corresponding to its equity share in the ECB. In addition, the value of the Bundesbank’s liabilities (the monetary base) does not depend on the value of its underlying assets. In a fiat monetary system (that is, a system in which a central bank defines what constitutes legal tender, as opposed to a “commodity money system”, such as the gold standard), central banks need assets only for the purpose of monetary control. They can, if they wish, create money out of nothing. But, in the end, the value of money depends only on its purchasing power, or the amount of goods and services that can be purchased with a unit of currency, which inflation can erode.
What can be done in the face of such a mammoth problem? Only one solution exists: a banking union. It is an absolute prerequisite for a healthier eurozone economy. A majority of independent analysts, economists and policy-makers have advocated the adoption of a federal framework for banking policy that would centralize the functions of supervision, crisis resolution and deposit insurance that are essential for the stability of the European banking system and therefore for the sustainability of the eurozone. A majority of independent analysts, economists and policy-makers have advocated the adoption of a federal framework for banking policy that would centralize the functions of supervision, crisis resolution and deposit insurance that are essential for the stability of the European banking system and therefore for the sustainability of the eurozone.33 I will review what this means in section 4.3.

KEY POINTS
- The sovereign and banking crises are completely intertwined
- Banks in the eurozone badly need to clean up their balance sheets
- Eurozone countries now favour domestic lending and shedding assets abroad
- Claims in TARGET2 are growing quickly
- Only one solutions exists: a banking union
3.3. The Competitiveness Deficit

Competitiveness matters considerably for national prosperity. For many years, the EU has been concerned with the competitiveness performance of its member states and has accordingly devised a number of strategies to improve it. In 2000, the EU launched the Lisbon Strategy, aimed at making Europe “the most competitive and dynamic knowledge-based economy” by 2010. It was a vain attempt. The strategy was criticized in retrospect for being too broad, covering too many issues and lacking a compliance mechanism to give the recommendations teeth.

Having recognized that they had not met their goals, European leaders in 2010 conceived a new competitiveness plan, the Europe 2020 Strategy, with the purpose of encouraging national and regional policies that could provide growth and jobs in the coming decade. It aimed to achieve innovation-driven, sustainable and inclusive growth. But much of the original good intent has since been side-tracked by the short-term firefighting of the financial and sovereign debt crises, which has prevented policy-makers from focusing on and investing in the measures needed to boost European competitiveness.

But what does competitiveness actually mean? The World Economic Forum has been studying Europe’s competitiveness since 1979, when the preoccupation was with how the region was faring compared with the United States. The Global Competitiveness Reports of the World Economic Forum define competitiveness as “the set of institutions, policies and factors that determine the level of productivity of a country”. The level of productivity, in turn, determines the level of prosperity that can be achieved by a particular country. The productivity level also determines the rates of return obtained by investments in an economy, which are the fundamental drivers of its growth rates. Put simply, a more competitive economy is one that is likely to provide high and rising living standards over time.

What are the key drivers of productivity and competitiveness? The main vehicle used by the World Economic Forum to measure competitiveness is the Global Competitiveness Index (GCI). The GCI is made up of 12 pillars of competitiveness. These range from the basic to the more complex and include political institutions and governance, infrastructure, macroeconomic stability, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation. Variables measuring each of these concepts are combined to come up with an aggregate score on a scale of 1 to 7, with 7 being the best possible outcome. The latest Global Competitiveness Report covered 144 economies.
On average, Europe trails other advanced economies in the creation of a smart, highly productive economy. This has had consequences on the region’s prosperity level. Indeed, as Figure 7 shows, the gap in terms of income per capita has widened between the EU27 economies and the highly innovative and productive United States over the past two decades. And while the 27 countries on average were significantly wealthier than the Republic of Korea in 1992, they have been overtaken by it since the beginning of this decade as South Korea has seen a significant improvement in its productivity and competitiveness.

**Figure 7: GDP Per Capita (PPP Int. $), EU27, United States and the Republic of Korea**

![GDP Per Capita Graph](image)

Source: International Monetary Fund, World Economic Outlook Database (October 2012 edition).

In large part, the widening income gap between Europe and some of the more competitive economies can be explained by a competitiveness deficit. As Figure 8 shows, when compared with the United States across several of these pillars, although the EU fares somewhat better on average in terms of its macroeconomic environment, it trails behind the United States in many other areas, most notably in the efficiency of its labour markets and its capacity to innovate.
A major issue for the eurozone is that a significant gap also exists among EU member states: some countries perform very well across the different pillars that determine competitiveness, while others do not. The Global Competitiveness Report 2012-2013 shows convincingly that countries with relatively high levels of economic prosperity but that lag in building a knowledge-based, highly-productive economy are those that have suffered the highest losses in terms of employment, salaries or both. In other words, high levels of prosperity in Europe cannot be sustained over time without high levels of competitiveness.

This competitiveness gap within Europe can be seen through the “heatmap” shown in Figure 9, with the most competitive economies indicated in warmest red and the hues becoming increasingly cooler, ending with the least competitive countries in dark blue. As the map shows, significant disparities in terms of performances exist across the continent. They range from the very strong performances of countries such as Finland, Germany, the Netherlands and Sweden, ranked at the top, to the poor and declining performance of Greece, ranked a low 96th out of 144 economies. More generally, the northern European countries are the most competitive and southern, central and eastern European countries the least competitive.
Figure 9: The Competitiveness Divide in Europe


To understand the areas driving this diverging performance, Figure 10 compares the performance across the competitiveness pillars between the northern and southern European economies.

Figure 10: The Competitiveness Gap: Northern vs Southern Europe

The Global Competitiveness Index, Pillar Scores (1-7 scale)
Notes:*Northern Europe: Denmark, Finland, Germany, Netherlands, Sweden
Southern Europe: Greece, Italy, Portugal, Spain

As Figure 10 shows, the divide between northern and southern Europe is significant across almost all areas. As well as macroeconomic stability, northern Europe receives a much stronger assessment for the quality of its institutional environment, the efficiency of markets, its propensity for technological adoption and innovation, among others. These significant differences, of course, constitute a serious problem when countries are bound by a common currency. Nations will follow divergent growth paths in the future, creating tensions among economies. At some stage, competitiveness and economic growth will have to converge between northern and southern Europe if the monetary arrangement is to survive.

A question remains as to the future path of France, a country with a less-than-stellar competitiveness profile as shown in the heatmap above. Ranked 21st, France trails the most competitive economies of northern Europe by a significant margin, despite a number of clear strengths, particularly related to the country’s excellent human capital base and propensity for technological adoption. Yet businesses in the country are saddled with an extremely rigid labour market and an often difficult regulatory environment. Amid discussions now taking place about the country’s economic future, one wonders whether France will become more “northern” or more “Mediterranean”, even as the Mediterranean eurozone countries to its south strive to address these issues.

Amid the current eurozone difficulties, inevitably the question also arises as to how the single currency relates to competitiveness. Could some countries have done better in terms of competitiveness by being outside rather than inside the eurozone? This is doubtful. Sharing a common currency prevents the external adjustment that a country can achieve by devaluing its currency, but this export-led recovery idea corresponds to a very narrow and mechanical definition of competitiveness, one that equates competitiveness with an improvement in the current-account position, which does not necessarily lead to longer-term growth.

Many industries in Europe rely to a significant extent on inputs from other countries, so the rising price of imports will undermine their competitive positioning on international markets. Moreover, the depreciation of a currency makes the citizens of the country poorer because it leads to an increase in prices of imports and therefore a decrease in real incomes, similar to a collective national pay cut when viewed from an international perspective.

As has already been seen among EU countries, divergent income levels and growth rates are to a very significant extent the result of differences in compet-
itiveness and productivity, the underlying factors of which are much broader. Indeed, some countries, such as Germany and the Netherlands, responded well to the incentives and discipline imposed by a single currency and succeeded in improving their economic performance. Others that took advantage of low interest rates to increase debt to finance unproductive investments did not do so well.

Would Greece, Italy, Portugal or Spain have fared significantly better outside the eurozone? Probably not, because without far-reaching structural reforms, they would have failed to prosper, no matter what.

These results in terms of divergence point to the complexity and difficulties of bridging the competitiveness divides in Europe and raise questions about the sustainability of the income convergence that many European economies have experienced in recent decades. The recent declines in income in previously converging economies, such as Greece, Portugal and Spain, where an important competitiveness divide persists, suggest that stable economic convergence may only be possible if decisive action to address the weaknesses in the competitiveness of these countries is taken.

Only by improving the competitiveness of the countries that are trailing and narrowing the competitiveness gap will Europe find a sustainable exit to the sovereign debt crisis and place the eurozone and the EU more generally on a path to more sustainable growth and employment.

### KEY POINTS

- Competitiveness is a robust predictor of prosperity and the potential for growth
- On average, Europe trails other advanced economies in terms of competitiveness
- Considerable divergence exists within the eurozone in terms of competitiveness
- Northern Europe is significantly more competitive than southern and eastern Europe
- Europe will be unable to address its current economic and financial difficulties if it does not close its competitiveness gap
3.4. Institutional Failure

When the European Coal and Steel Community was founded in 1951, there were six participating states. Today, the European Union has 27 members. This dramatic increase brought with it the enlargement of European institutions and regulatory bodies to such an extent that complexity and maintaining legitimacy have become significant challenges. The reality of institutional failure boils down to this: Europe is perceived as a faceless entity. The crisis has shown that the governance of the EU’s political economy is too weak. The executive authority is dispersed among too many different and fairly obscure institutions and players, and democratic accountability is thin.

The three main institutions that compose the EU – the European Commission, the European Council (representing the national governments), and the European Parliament – are at best misunderstood and at worst disliked by a majority of the European population. The European Commission is a case in point. It is perceived and resented as a refuge for technocrats and civil servants while it is in reality a successful institution with a reputation for competence.

As shown in Figure 11, trust in the European Union at large has declined since autumn 2011 and is currently at its lowest ever (31%, -3 percentage points). At the same time, levels of trust in national governments and parliaments have recovered slightly (28%, +4 and 28%, +1 respectively), such that the gap between trust in national political institutions and in the European Union is currently very narrow.

**Figure 11: Trust in National Governments, Parliaments and in the European Union, 2006-2012**
Essentially, the much talked-about democratic deficit stems from this institutional failure. The lack of trust in European institutions derives from their lack of legitimacy when compared to the elected governments of nation states. It has several different aspects:

- The European Council, a key player in Europe’s collective executive decision-making, lacks the framework to ensure collective accountability. Its members, heads of state or government, are exclusively accountable to their respective national citizens, but the Council as a whole is accountable to no one. The same shortcoming hampers the summit meetings of the eurozone, as well as other intergovernmental formations such as the Economic and Financial Affairs Council (ECOFIN) and Eurogroup (the eurozone finance ministers). The European Commission has stronger accountability to the European Parliament, but in the past five years it has often been sidelined (with important exceptions, such as on competition policy – placed directly under its authority).

- When electorates in individual member states are consulted on successive treaty revisions by referendum, negative responses should be answered by a change of orientation. This has not been the case. The French and Dutch rejections of the 2004 constitutional treaty were followed by the reintroduction of nearly identical text as the Lisbon Treaty in 2007. Similarly, the Irish were asked to vote again on the Lisbon Treaty in 2009 after first rejecting it in 2008. Nothing crystallizes better this sense of institutional “flop” than the failure of the Lisbon Treaty. Signed in 2007 before entering into force in December 2009, it was destined, according to its preamble, to “enhance the efficiency and democratic legitimacy of the Union and to improve the coherence of its action”. However, a large majority of EU citizens perceived it as so complex as to be incomprehensible. The problem of the “three presidencies” highlights this. One is the “rotating presidency”: the president of the Council of the EU that rotates among member states every six months. Another is the permanent president of the European Council (also known as the president of the EU summits of heads of state and government), Herman Van Rompuy of Belgium. The third is the president of the European Commission, José Manuel Barroso, often portrayed as yet another EU president. This arrangement is rather confusing for anybody not familiar with the subtleties of EU decision-making!

- European citizens lack equal representation in the European Parliament. In June 2009, this critical shortcoming was cited by Germany’s federal constitutional court as a key reason not to surrender national fiscal power.
to Brussels. In addition, the European Parliament does not control financial and other important executive decisions.

The democratic shortfall of European institutions has been widely cited as a factor in the rise of populist anti-European parties in recent elections in several member states. It extends to some of today’s most critical decisions. Certain commentators such as Gideon Rachman, the chief foreign affairs correspondent at the Financial Times, have argued that the ECB’s decision in September 2012 to engage in unlimited bond purchases is “immune to democratic controls”,37 highlighting the fact that European voters are subject to crucial decisions about national economic policy that can no longer be challenged at the ballot box. Rachman points in particular to Germany, where the realization is growing, he believes, that the ECB is an unelected body independent from government that has just made a decision with profound implications for German taxpayers – but one that they can neither challenge nor change.

This institutional failure can lead to policy paralysis in situations of stress. One of the reasons why the crisis became so acute is the inability of European leaders to make decisions when they are needed. This curse of ineffective government just when a tough situation most requires fast, effective and decisive action has plagued the European decision-making process from the onset of the crisis.

With the notable exception of the European Central Bank, European leaders and institutions have generally projected an image of collective indecision rather than decisiveness, well captured by the criticism that they are merely “kicking the can down the road”. It is fair to say that, alongside a democratic deficit, Europe also suffers from an executive deficit – “the true core of the European crisis”, according to the researcher Nicolas Véron, who has argued that European institutions suffer from the absence of a mechanism to allocate losses – a key feature of executive power.38 This is a major reason why Europe has been unable so far to resolve its banking crisis.

It is fair to say that Europe’s political leaders must act within national, European and even international systems and constraints, rendering decision-making slow and sometimes chaotic. In addition, the natural tendency in any complex situation, where decisions may have unintended consequences, is to wait until the last moment in hopes of gaining greater clarity.

To make the EU capable of decisive action, several things must be streamlined and simplified, most notably: (1) the decision-making processes, (2) the distribution of power between EU institutions and the nation states, and (3) the interaction between the multiple EU institutions. I shall return to each later in this book.
KEY POINTS
– The complexity and legitimacy of European institutions has caused a democratic deficit
– The curse of ineffective government has exacerbated the crisis
3.5. The Disintegration of Common Values

For many years prior to the 1990s, the process of European integration was embraced and supported, albeit often passively, by a large majority of Europeans. In Western Europe, the project was regarded as an effective buffer against the “Barbarians at the gate”, a.k.a. the Soviets. In Eastern Europe (the “kidnapped West” as writer Milan Kundera called it), the idea of European unification and the sense of common democratic values with the West were closely associated with the struggle for freedom, admittedly alongside the lure of Western prosperity.

These powerful drivers that led to a sense of common European values came to an end with the fall of the Berlin Wall in 1989. In September 1992, France – the heartland of the unification project with Germany – adopted the Maastricht Treaty by referendum with only a tiny majority. In Germany, where the constitution did not demand a referendum, Chancellor Helmut Kohl simply stated that citizens would have to abandon their cherished deutsche mark against their will. This proved a dramatic turning point, after which the project of European integration became increasingly perceived as driven by the elites for the elites and devoid of common values.

To a certain extent, this feeling that far-reaching European decisions are taken in an opaque fashion, without explicit reference to a set of common values, coincided with the disintegration of the democratic principle embedded in the European ideal. The founders of Europe wanted a “united democratic Europe” that gives each person a vote and, most importantly, also a voice. Today, the democratic principle embedded in elections is firmly instituted in the constitutions of all European countries. However, the commitment to public discussion (as in Switzerland) in preparation for large policy decisions is often left wanting.

If democracy, as the British political analyst Walter Bagehot defined it, is a “government by discussion”, then the democratic ideal has been perverted. Indeed, most of the decisions that will determine what Europe will be like tomorrow are made by experts and technocrats without much (if any!) public discussion. The unilateral judgements of central bankers and financial experts, and the pronouncements of rating agencies reign supreme, without proper public debate. “The disdain for the public could hardly have been more transparent in many of the chosen ways of European policy-making,” Amartya Sen wrote in an essay in The New Republic.

In this respect, an analogy that is deeply misleading is often invoked in the media, based upon the idea of an imaginary set of common values. Many
commentators and pundits have portrayed the current predicament in the south of Europe and German sacrifices to achieve unification between its East and West as similar. This analogy is a false comparison because what drove the process of German unification was precisely a shared sense of values and identity. Clearly, the sense of national unity that spurred the German effort does not exist to the same extent between southern Europe and the rest of the continent.

As illustrated in Figure 12, a deep and increasing sense of disillusionment pervades the European ideal. It is in this sense that the disintegration of common values is intertwined with the notion of democratic deficit discussed in the preceding section. The crisis has created a crisis of faith in the ideal of democracy itself. More worryingly, it has also created a phenomenon of distrust in politicians and political institutions.

This is especially true in the hardest-hit countries of southern Europe. In Spain, a recent survey showed that trust in political parties is at 9%, an all-time low. Some 27% of Spaniards have faith in trade unions, the local councils and the Supreme Court, while 23% express confidence in the current government, and just 16% trust the parliament. In Italy, only 7% trust political parties. The numbers do not look much better in other southern European countries.41

The greatest risk that has arisen from all this is the rise in populism and the hidden danger of radicalization. In Greece, for example, parties from the far-left and the extreme-right, which both refuse to implement the conditions imposed by the bailout and call for an exit and a default, achieved their best results ever in the June 2012 general election. In Ireland, the mainstream Sinn Fein party has attracted unprecedented levels of public support by attacking the country’s bailout by the Troika of the IMF, the ECB and the European Union. In Portugal, the Communist Party and the Left Bloc have surged in opinion polls.

In Italy, meanwhile, the recently created Five Star Movement of Beppe Grillo, who rejects the euro, austerity and the political establishment, won about 10% of votes in participating provincial capitals in local elections in 2012 (twice as many as in the regional elections held in 2010), and received more than 18% of votes in Sicily’s regional elections in October 2012. During the 2012 presidential elections in France, Marine Le Pen, the leader of the extreme-right National Front, who advocates an immediate exit from the euro, achieved 18% of votes, including a high level of support among the young. Jean-Luc Mélenchon from the Left Front, who has a similar position on Europe, won more than 11% of the overall vote. And so on. It is no surprise that in such conditions the image of the EU has deteriorated steadily since the beginning of the crisis, as shown in Figure 12.
Figure 12: The EU’s Image, 2006-2012

Recent polls and elections show that the rise in extremism should not be considered a foregone conclusion – far from it. In what was widely perceived as a European test case, the general elections that took place in the Netherlands in September 2012 handed victory to the most pro-European political parties and (relative) defeat to the anti-European platform put forward by the Party for Freedom of Geert Wilders.

So where are Europe’s common values to be found today? Not in a sense of belonging. Contrary to the situation that prevailed when the EU institutions were first formed, today’s European citizens identify first and foremost with their country of origin, not with Europe. A survey conducted by the World Economic Forum in 2012 of its Young Global Leaders and Global Shapers reveals that among the 75% of respondents who have a European passport, only 23.2% would identify themselves as European. Respondents instead describe their primary identity as global (46.4%) or national (24.6%). These results do reveal that the next generation will increasingly look at Europe from a global perspective. This may become a driver for European unification, as the next generation recognizes that Europe can only prosper in the international context if it is united.
At the moment, the fear nonetheless exists that Europe’s common values are fast vanishing into the mire of diverging national, and sometimes regional, interests so prevalent in times of great stress. Many national media are awash with ethnic stereotyping, lambasting the lazy Italians, the lying Greeks or the imperial Germans.

What is to be made of this situation and of the many different speeds in the EU? Some countries, like Germany, are willing and able to integrate quickly, while others, like the UK, are applying the brakes. Why do Northerners – the Belgians, Finns, Germans and others – escape to the South in the summer? Simply for the sun, or are these temporary migrations destined to break the ethos of prudence and discipline in search of the delightful inefficiency and sensuality of the Mediterranean culture? Are they in search of a different set of values?

The Germans have a word for this: the Volksgeist, which can best be translated as “national spirit”. Will a common set of European values that transcends the Volksgeist emerge in the foreseeable future? This can only happen if policy-makers and opinion-shapers succeed in instilling a shared vision for Europe. Section 4.7 looks at how best this might be done.

**KEY POINTS**

- European common values disappeared in the 1990s
- They have been replaced by distrust in politicians and political institutions
- In situations of crisis, the absence of common values leads to populism and radicalism
3.6. The Erosion of Global Credibility

The year 2005 was probably the apogee of the European idea. Until around that time, the European project of integration was perceived globally as the most far-reaching, ambitious and constructive attempt yet to unite a continent that had been war-torn throughout history. This high-minded endeavour is now in tatters. Today, the eurozone is kept together by fear. It is only the spectre of collapse and the devastating economic and social consequences that a disintegration of the euro would entail that are keeping it alive.

This is not conducive to an outward-looking Europe, proud of its identity, dynamic and enjoying the active support of its citizens. If it is not to decline further in terms of its relevance and efficacy, Europe must find a new driving force and fully mobilize its population for the effort.

I shall return to this later on in the book and focus for the moment on Europe’s lack of credibility internationally. This stems from the image of division and hopelessness that the continent often projects abroad. Despite the recent creation of a European External Action Service (EEAS), Europe never had a single or unified voice in world affairs. The mixed and sometimes contradictory reactions of different EU governments to the Arab Spring have highlighted the embarrassing lack of common foreign policy. Most importantly, they have shown that no one is in charge to define Europe’s role in a fast-changing world.

The EEAS is small, with only 1,500 diplomats and an annual budget of less than half a billion euros. By contrast, Europe’s combined national missions employ 55,000 diplomats and cost 7.4 billion euros a year. In 2011, a report from the Brookings Institution concluded: “It is clear that the EU’s foreign policy has evolved as a patchwork, an ugly amalgam of different issue areas that were thrown together with little thought to overall strategy.”

Javier Solana, former Spanish foreign minister and European Union foreign policy chief from 1999 to 2009, put the issue this way: “The choice is simple: either we Europeans act in unity to confront the tremendous challenges presented by the tumultuous changes now underway in the world order, or we doom ourselves to act as spectators in a world in which we have little or no say. Our prosperity and the viability of our socioeconomic model are at stake. That should convince us that Europe’s states are too small to act globally on their own, and that European integration is the only viable path.”

Should a country decide to leave the eurozone or simply withdraw from some EU institutions, the blow to the project of integration and European prestige
would be considerable. It is still a distant risk, but nonetheless conceivable. Today, the United Kingdom is at a crossroads regarding its EU membership, and so are its most important EU counterparts, particularly Germany. For the first time since the 1970s, when maintaining the UK in the European project was paramount, France, Germany and other European countries worry more about safeguarding the euro and EU's existing institutions than keeping the UK within the EU. In the words of a British commentator, “British pull is now being reinforced by continental push.”

The necessity to put into place structural and institutional reforms to save the euro may ultimately lead to a multi-speed Europe, with core countries continuously strengthening the EU’s economic and political union and peripheral countries being tied to the core through more flexible, looser arrangements. Since the core would certainly comprise most of the continental European countries and the original founding member states of the EU, such a solution is certainly much less desirable than a unified Europe of at least 27 countries. But it is still preferable to possible disintegration.

**KEY POINTS**

- The image of Europe has sharply declined, both in terms of relevance and efficacy
- Europe has no common foreign policy
- Should a country leave the eurozone or the EU, the blow to the project of integration would be considerable
- A multi-speed Europe is preferable to disintegration
Disagreements abound among policy-makers and experts on how Europe should move forward. The overarching consensus, however, is that a considerable effort of transformation and adjustment lies ahead. Sacrifices already incurred by most eurozone states and citizens are bound to get worse. No matter how one looks at it, there is no easy, straightforward or painless way to resolve the eurozone crisis successfully. Time, effort, stamina and resilience will be needed.

Many commentators describe the necessary changes as daunting. That may be, but they are not unachievable. Obviously, the fragmentation of Europe’s financial, economic, social and political space since the crisis began is a great cause for concern. But there is still time to act. The eurozone faces considerable challenges but is far from condemned to failure. It might even – and probably will – emerge stronger from the current predicament.

Many turning points and game-changers have occurred since the onset of the crisis. The decision announced by ECB President Mario Draghi on 6 September 2012 to engage in the unlimited purchase of government bonds is one such moment that unequivocally signalled a real determination to keep the eurozone together. There are conditions, however. The ECB will only purchase the bonds of debtor countries with a maturity of up to three years when and if the countries concerned can get agreement from the European Financial Stability Facility. In other words, these countries will have to put themselves under the authority of the Troika – the IMF, the ECB and the EU.

With this fundamental decision, the euro crisis entered a new phase. Barring an unforeseen catastrophe, the continued existence of the euro is assured. By and large, the future shape of the European Union in general and the eurozone in particular will be determined by the political decisions and the structural measures taken by member states in the next year or so.

Four types of unions are needed to avoid a disorderly and disastrous eurozone break-up: a banking union, a fiscal union, a competitiveness “union” or convergence, and a political union. In the longer term, the EU cannot survive sustainably unless it reintegrates its youth and presents an ideal worth fighting for.
4.1. Exiting the Euro: A Bad “Good” Idea

Many influential economists and pundits (but no European policy-maker) have suggested that devaluation should be part of the solution. In my opinion, this fallacy gave the misleading impression that an easy way out of the crisis is possible. In so doing, it exacerbated the crisis in 2010 and 2011 by creating unnecessary, time-wasting and distracting noise around the policy options.

During those two years, many editorials, articles and scholarly pieces argued in favour of devaluation, meaning an exit from the eurozone and the reintroduction of the national currency that preceded the euro. Proposals for such an idea were widespread and gained traction in some corners. Today, this idea is much less prevalent because very few believe in the possibility of an orderly exit.

An overwhelming number of economists, international civil servants and policy-makers argue that a fragmentation of the eurozone would cause a new depression and massive wealth destruction around the world, and would also end the period of economic integration that has characterized world politics since the end of the Cold War. All banks that have looked at the implications of a euro break-up reach roughly similar conclusions. UBS estimates that it would cost each southern European economy up to 40% of their GDP in the first year. ING predicts that the eurozone as a whole, including Germany, could see a 9% drop in GDP in the first year following break-up, with inflation in the periphery soaring to double digits.45

I will illustrate in detail why the idea of devaluation is, in my opinion, a fallacy. In short, the cost would exceed by far the supposed benefits.

First, it is worth mentioning that the adoption of the euro is effectively irreversible. There is no legal framework for a member country to re-establish its own currency and no member country can expel another. Therefore, leaving the eurozone has to be an individual nation’s choice when it believes it will be in its best interest.

The cost of leaving the euro would have far-reaching implications for a country’s politics, its finances and economy, its society and its future. Simply put, the economics of leaving look very dubious while the politics would be horrendous. I briefly examine below the most obvious consequences.

- **Political impact:** If even one country, large or small, were to leave, the eurozone would effectively rupture. The notion of solidarity established by the EU’s founding fathers as the cornerstone of the continent’s future
would be broken. If a more productive economy such as Germany were to exit, it would mark the end of a 60-year commitment to a stable Europe. If a less productive economy decided to leave, it would almost instantly become a pariah exporting its pain to its neighbours. Some pundits even speculate that a country leaving the euro would reignite long-buried rivalries and tensions, and break the European project irrevocably.

- **Technical and organizational challenges:** The change from one currency to another would need to be carried out quickly and in full to limit financial chaos. Many different actions would have to be coordinated simultaneously. The national parliament would have to pass laws fixing the exchange rate for a new currency that would pay everything from sovereign debt to teachers’ salaries. Beyond the public sector, savings, mortgages, share prices, and everything else from pay slips to ATMs would require shifting. In parallel, new coins would have to be minted, new currency printed and new interest rates set by the central bank. Exiting the euro would require the reverse engineering of a process that took three years to put into place.

- **Legal challenges:** In Argentina in 2002, a forced devaluation and banking restrictions limited the circulation of cash. Anyone unable to withdraw their money in time took to the courts. In similar circumstances, individuals and institutions would sue in any jurisdiction available. Whether they were successful or not, the uncertainty would provoke a credit crunch. The huge legal bill would be yet another barrier to any country trying to set up its own currency.

- **Banking:** If a creditor country left the euro, money would rush in and its new currency would rise sharply. The reverse would happen for a debtor country. Departure from the euro would trigger a bank run as depositors scrambled to move savings abroad. Faced with such a risk, there would be little choice but to impose limits on bank withdrawals and other capital controls. Restrictions on foreign travel may even have to be applied. This would further hit the economy by depressing commerce and trade, and cutting the country off from foreign credit.

- **The economy:** Here is how the scenario unfolds: (1) depositors shift money to other eurozone banks or countries to protect their savings and cut spending drastically, (2) subsequently, there is a run on the banks (this is already happening in slow motion in some countries), further capital outflows and asset sell-offs, (3) investors dump bonds, (4) then, with foreign debt still denominated in euros, the country leaving the eurozone is virtually guaranteed to default, (5) its own banking system struggles to stay solvent, and so too do banks across Europe, (6) the exiting state can no longer access international capital markets – possibly for years – and is forced to bring its budget into balance immediately. If this devastation has
one positive outcome for a country, it is that its debt, now redenominated in the new currency, is most likely to be significantly lower and the new currency now better reflects the fundamentals of its national economy, going up in more productive economies and going down in less productive ones.

Table 3 shows what happened to currencies in similar circumstances. It is obvious that devaluation can often get out of control.

Table 3: Currency Devaluations in the Context of a Debt Crisis

<table>
<thead>
<tr>
<th>Currency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK pound (1992-1993)</td>
<td>-28%</td>
</tr>
<tr>
<td>Chinese yuan (1993-1994)</td>
<td>-35%</td>
</tr>
<tr>
<td>Mexican peso (1994-1995)</td>
<td>-60%</td>
</tr>
<tr>
<td>Asian crisis (1996-1998)</td>
<td>-55%</td>
</tr>
<tr>
<td>Russian rouble (1998-1999)</td>
<td>-75%</td>
</tr>
<tr>
<td>Brazilian real (1998-1999)</td>
<td>-45%</td>
</tr>
<tr>
<td>Turkish lira (Jan.-Oct. 2001)</td>
<td>-60%</td>
</tr>
<tr>
<td>Argentine peso (Jan.-June 2002)</td>
<td>-74%</td>
</tr>
<tr>
<td>Brazilian real (April-Oct. 2002)</td>
<td>-40%</td>
</tr>
</tbody>
</table>

Note: The Asian crisis figure includes Indonesia, South Korea, the Philippines and Thailand. Source: Monthly Barometer. www.monthlybarometer.com

There are two conditions for when a country is right to devalue to restore its competitiveness. First, the currency is overvalued in real terms (this is certainly true for deficit countries in the eurozone). Second, the current account is expected to be in deficit for the foreseeable future. These two preconditions are met in the case of southern Europe, which is why it is so tempting for many to argue for devaluation.

But for it to be effective, three things have to happen:

1. The devaluation has to be real. What that means is that the devaluation must have a bigger effect on prices than on the underlying inflation. In other words, the country’s goods become relatively cheaper on international markets.

2. For devaluation to work, inflation has to be under control. Achieving that would entail all the familiar measures – a balanced budget, controlled public spending and tight monetary policy.
3. It is necessary to make sure there is no over-devaluation to prevent an adverse reaction in capital markets, which could lead to the very inflation the government is trying to prevent.

Getting all of these right is extremely difficult, especially in southern European countries, where wages cannot adjust.

So what if a country could meet all these conditions and leave the euro? What would happen next? To get the benefits, a country has to be able to boost exports and make its tourism and service industries more attractive internationally. If a country cannot do this, it will miss out on the substantial gains from the devaluation. In other words, tackling poor competitiveness is necessary for any country, no matter what. Restructuring the economy over the long term cannot be avoided.

**KEY POINTS**

- There cannot be a devaluation without an exit
- The cost of devaluation would by far exceed its supposed benefits
- A devaluation would not address the structural reasons behind poor competitiveness
4.2. Fiscal Discipline and Economic Growth

The debate rages over what governments should do with respect to the immensely complex trade-off between fiscal discipline and growth. At one end of the spectrum, a rather simplistic Keynesian remedy assumes that government deficits do not matter when economies are in such deep recession as is currently the case in southern Europe. At the other end, the debt-ceiling absolutists want governments to start balancing their budgets today, if not yesterday. Both arguments are extreme and facile.

Those who advocate tough fiscal discipline often underestimate the massive adjustment costs that a sudden stop in debt finance imposes on the economy and society. The logic according to which governments – like each of us – should balance their budget is appealing. Yet cutting expenditure drastically and rapidly is far from simple. A government always has thousands and thousands of ongoing expenditure commitments ranging from defence and infrastructure projects to education and healthcare. Walking away from this myriad of commitments overnight is impossible. In democratic systems, moving fast involves difficult negotiations and tough political choices.

Today, few would dispute the fact that economic growth in the eurozone has been substantially undermined by the fiscal contraction imposed upon southern Europe. Very low or negative economic growth affects the generation of public revenue, which in turn reduces the ability of governments to cut deficits. As the economists Kenneth Rogoff and Carmen and Vincent Reinhardt have argued in a recent paper, however, the massive accumulation of debt that characterizes Europe and almost all rich countries is not a “free lunch”. Very high debt levels (of 90% or more of GDP) reduce economic growth for at least two decades, the authors show. Furthermore, the cost of the debt accumulates over time. After a quarter century, income can be even lower than in normal circumstances. The drag on growth, they argue, normally results not only from the inevitable need for the government to raise taxes but also from lower investment spending. Thus, crucially, any form of government spending can provide a short-term boost but the trade-off is long-run decline.

Hard-core Keynesians would disagree and argue that a great body of evidence in economic history suggests that the best way to cut deficits over the longer term is to spend during recession and curb spending during periods of economic growth. That is what happened with the huge deficits caused by World War II: they disappeared thanks to the rapid economic expansion experienced in the years following the War. A similar phenomenon took place in the US during Bill Clinton’s presidency. His administration started with a very large
deficit and ended with almost none. Similarly, the reduction in the Swedish budget deficit between 1994 and 1998 also took place during a period of rapid economic expansion.

Today, the situation is radically different. In effect, many countries are being asked to cut deficits or are cutting them without being asked (as is the UK) while experiencing negative or very low economic growth. This imposes the discipline of austerity on top of the recession. Another major difference is that the entire world is simultaneously facing deficient aggregate demand. That is why the manufacturing prowess achieved by Germany after reunification would be so hard to replicate under current economic conditions, which are so dissimilar from those that prevailed in the 1990s. Then, despite a ballooning debt burden, Germany introduced far-reaching labour market reforms. A change in the constitution required that the federal budget be balanced by 2016. Those changes were possible because of an export-led recovery, helped by a boom in housing and consumption across Europe.

This is no longer the case. Currently, the global financial system has started to deleverage, while global trade is stalling. Therefore, the fiscal austerity pursued in Europe is exacerbating this global phenomenon and may well push the continent into a deflationary debt trap. If heavily indebted governments reduce their budget deficits simultaneously, their economies contract, with an increase in the debt burden to GDP ratio the perverse result. For this reason, monetary authorities around the world have engaged in unconventional monetary policies – the only way to avoid a deflationary trap, out of which it would be exceedingly difficult to escape.

Some of the most prominent and vocal economists and opinion-makers, led by Paul Krugman, Joseph Stiglitz and Martin Wolf, among others, have therefore consistently argued that the current policy of austerity is misguided and, more importantly, counterproductive. Their argument is as follows: it is the wrong time to worry about sovereign debt because in a recession caused by an increase in private-sector savings, itself a manifestation of deleveraging, the public sector must run a matching deficit to prevent a fall in output.

Now, if the world is considered in its entirety, private-sector surpluses must fall to compensate for the reduction in government deficits. In normal conditions, lowering real interest rates would encourage the private sector to save less, but this has not happened. The ECB has already implemented a very lax monetary policy with very low nominal interest rates, while not letting real interest rates fall by encouraging above-target inflation in the future.

Those who claim that reducing government debt will boost confidence and therefore private spending are pursuing an argument of hope over both theory and evidence, the anti-austerity economists insist. For the Keynesians, the last two years show that the fall in the private-sector surplus, which was needed
to match lower public debt, can only occur when output and incomes drop, which in turn not only prolongs the recession but also intensifies it.

The logical consequence of the above is that, without spending and growth, there will not be any solution to Europe’s problems. In the absence of private spending, budget cuts will only depress tax revenues, which will then require additional budget cuts. This generates an adverse feedback loop, with no economic growth at the end of the tunnel, therefore diminishing political support for structural reforms.47

This narrative rings true for Europe. Despite having very different economic policies, the US and the UK have followed a similar economic pattern as the eurozone, as shown in Table 4. This is puzzling. If austerity is defined as reducing the rate but not the level of deficit spending, then the US, UK and eurozone appear to have lowered their fiscal deficits at about the same rate.

**Table 4: Economic Patterns in the Eurozone, the US and the UK**

<table>
<thead>
<tr>
<th></th>
<th>GDP per capita in 2012 (as % of 2007 peak)</th>
<th>Increase in unemployment rate</th>
<th>Fiscal deficit in 2012</th>
<th>Austerity (measured by the fall in deficit since 2009 peak)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EZ</td>
<td>97.3</td>
<td>3.4</td>
<td>3.2</td>
<td>3.2</td>
</tr>
<tr>
<td>US</td>
<td>98.5</td>
<td>3.2</td>
<td>8.3</td>
<td>3.3</td>
</tr>
<tr>
<td>UK</td>
<td>94.3</td>
<td>3.6</td>
<td>8.0</td>
<td>3.4</td>
</tr>
</tbody>
</table>


People tend to think in binary terms – this or that, black or white, budgetary discipline or growth. Binary thinking has the advantage of being simple but it can also be misleading. A third way often exists. In the case of the debate on growth versus austerity, a combined approach would recognize that austerity is a necessity while also pursuing growth through structural reforms particularly in the labour markets, product regulation and a mix of government spending. Remarkably, some policy-makers in southern Europe have already begun to move down this path. Italian Prime Minister Mario Monti has championed this approach, with the active support of the IMF. On several occasions, he has advocated the need for budget austerity along with a growth agenda. The IMF has shown that the liberalization of labour laws, softening of regulatory strictures and adjustment of budget priorities towards those that provide an economic return could alleviate the pain inflicted by austerity alone. Over the next five years, such measures could add 4.5% to GDP growth, a premium of almost one percentage point a year.48
The Baltic countries have had success with the mixed approach. To a large extent, Estonia, Latvia and Lithuania have succeeded in combining growth and austerity. Granted, they are very small and open economies whose reforms were supported by two factors that do not currently exist in the eurozone – a strong external market for exports in Scandinavia and a backstop for the banking system provided by Swedish banks. They are also structurally very different from Greece or Spain. Their turnaround, driven largely by manufacturing for export, is nonetheless remarkable.

This illustrates how conventional wisdom can sometimes get it wrong. In 2008-09, the Baltics were all hit by a nearly complete liquidity freeze and their economies plunged by as much as 24% of GDP. Their recession lasted two years, during which they pursued a relentless programme of austerity. In 2009, their fiscal adjustment amounted to a punishing 9.5% of GDP, accompanied by structural reforms. In 2010, a majority of pundits and market participants had written off Latvia, which came under fire for trying to peg its currency to the euro. The overwhelming consensus then was that Latvia would have to drop its peg to restore competitiveness. But the pace of adjustment was astonishing. By 2011, Latvia’s growth rate was 5.5%, compared with 7.6% in Estonia and almost 6% in Lithuania. Meanwhile, all three countries had regained access to international financial markets, thanks to credit ratings that had risen steadily since the summer of 2009.

I reiterate that the example of the Baltic countries cannot be replicated and they are not yet out of the woods, but their relative success nonetheless shows two things: first, that reforms written off as impossible can be achieved and, second, that there can be life after austerity!

An absolute prerequisite for the resumption of growth in Europe is renewed confidence in the future of the eurozone. The current uncertainty about whether the euro will survive intact has, to a very substantial extent, affected confidence not only among market participants but also among economic agents in general. Everybody is more cautious. Consumers spend less, producers produce less and hire fewer employees, and investors defer making investment decisions.

**KEY POINTS**

- Current economic circumstances differ from those in the 1990s: today the world is suffering from a lack of aggregate demand
- Excessive austerity can be self-defeating...
- … but the excessive accumulation of debt is not a free lunch
- Mixed approaches try to reconcile growth and austerity
4.3. Rebalancing and Conditions for Sustained Growth

It is an open question as to whether Europe could have grown sustainably without the single currency. It is indeed important not to forget the major economic advantages the euro has provided. First and foremost, it eliminated exchange risk – a benefit so obvious that very few people think of it! Second, it led to lower inflation. Third, trade within the eurozone increased. And fourth, European financial markets became more integrated.

More generally, the euro has contributed to an underlying culture of monetary stability and economic predictability within the eurozone, a critical point too often forgotten in today’s discussions. Irrespective of what one’s conviction may be, everybody agrees on the following: it is impossible to have a single currency without some form of common fiscal policy. Hence the Fiscal Stability Pact, which sets strict new rules about deficits and debt, was signed by 25 EU countries (the UK and the Czech Republic opted not to join) in March 2012.

Influential market participants and opinion-makers have suggested that EU countries should go much further. George Soros, for example, has advocated a much more important role for Germany, going as far as recommending that Germany either decide to become a “benevolent hegemon” or simply leave the eurozone. The latter would amount to a nuclear option. According to Soros the former is by far the better alternative, but it would require two new objectives that, according to him, are “at variance with current policies”. These goals are:

1. “Establishing a more or less level playing field between debtor and creditor countries”, which would mean that they would be able to refinance their government debt on more or less equal terms.

2. “Aiming at nominal growth of up to 5 percent, in other words allowing Europe to grow its way out of excessive indebtedness. This would entail a greater degree of inflation than the Bundesbank is likely to approve.” It may also require a treaty change and a change in the German constitution.

The rebalancing between surplus and deficit countries within the eurozone must be guaranteed by a banking and fiscal union.

In practice, a banking union would mean agreement on a framework for supervising the banks, ensuring deposits and resolving crises. A fiscal union would effectively mean issuing eurobonds. Such instruments could be designed in
many ways. However, any method would curtail the freedom of individual nation states to set their public budgets.

All these measures will be needed to keep the eurozone alive. Banking and fiscal unions would not resolve the crisis. They would, however, address some of the obstacles that have barred progress for the past five years. To get there involves thinking about political obstacles, interdependencies and sequencing. For example, banking and fiscal unions tend to be supported by debtor countries as a way to spread their liabilities with creditor countries. But in return, creditor countries want more decisions taken centrally on banking supervision and fiscal and competitiveness policies.

In the absence of a full fiscal union, which requires a political union and therefore cannot be achieved overnight, a banking union is critically important. Without one, banks are “de facto contingent liabilities of their own individual sovereign state,” Erik Nielsen, the global chief economist at the European financial group UniCredit, wrote in an essay published in the Financial Times. He suggested that this has two negative implications:

1. When countries and their banks are so intertwined, investors have to charge a premium on the funding costs of the banks that is implied by the sovereign risk of the home country of an individual financial institution. In the most exposed or weakest countries, this means that the private sector will have to pay higher costs for borrowing.

2. National bank supervisors are likely to limit the exposure of their banks to foreign risk, essentially meaning banks in southern Europe. This amounts to a restriction in capital movements and therefore widens the differences in monetary conditions within the eurozone.

As a monetary union cannot function under these two limitations (internal capital controls and substantial differences in monetary conditions), a banking union is therefore an absolute prerequisite to prevent a possible implosion of the eurozone. It can best be described as “part of the hard-wiring of a monetary union.”

A robust banking union must consist of three things: shared bank supervision, a shared bank resolution or recapitalization mechanism, and a shared bank deposit guarantee. On 12 September 2012, the European Commission moved on the first item by proposing a single supervisory mechanism (SSM) for banks that will be led by the ECB. This should in principle be in place by 1 January 2013. The two other components are destined to follow.

Although these commitments and timetable were confirmed at the European Summit in October 2012, discussions on concrete proposals are bound to be very complex, technical and controversial. First, the European banking systems
are very heterogeneous: France, for example, has mainly systemically important banks (i.e. institutions that are “too-big-to-fail”), while Germany has one globally recognized institution – Deutsche Bank – alongside many small local savings banks. Second, mistrust between European countries and each of the national regulators is common. In most cases, they also hold very different views. These difficulties raise concerns that efforts towards the establishment of a banking union may have already stalled.

At the end of September this year, German, Dutch and Finnish finance ministers called the deal into question by insisting that the “legacy assets” (banks that were in trouble prior to the establishment of the supervisory mechanism) would be excluded from the rescue scheme. As always, the devil is in the details. While a plan may be in place, the tremendous constitutional, legal and political issues that arise from the establishment of a supranational supervisor could take many years to address.54

Nevertheless, negotiations for a banking union will drag on and will inevitably lead to talks on a fiscal union, as the different pieces of a new, improved eurozone are put together. The idea of banking supervision without a fiscal backstop or lender of last resort does not make sense. This would mean that “national taxpayers have to pay for the failures of the European Central Bank supervisor,” according to French economist Jean Pisani-Ferry, director of Bruegel, a Brussels-based think tank. “A common fiscal backstop without common resolution would also be a recipe for conflict as national resolution authorities would have every incentive of shifting costs on to the European taxpayer instead of ‘bailing in’ the banks’ creditors”.55 He further observes: “Having one element missing or poorly designed would undermine the whole.”

During this lengthy process, fraught with uncertainties and difficulties, the eurozone members must act to limit market uncertainty about the ultimate fate of their most significant banks. Philipp Hildebrand, the former chairman of the Swiss National Bank, and Lee Sachs, a former counsellor to the US Treasury secretary, have suggested an approach that worked in the US in 2009. It consists in the following: first, governments assess the balance sheets of the largest banks and set robust capital requirements for each; second, they commit to providing public capital if it is determined that these banks need more funds but cannot raise the money from private sources to meet the higher standards. This, in their view, is the only way to restore confidence in the banking system, which can in turn ease the flow of credit to enterprises and consumers.56

Many other suggestions have been put forward. Generally, they tend to converge with those presented by the economic historian Niall Ferguson and economist Nouriel Roubini at a meeting in Rome in July 2012:

- “The current policy that recapitalizes banks within countries in trouble that are borrowing from their domestic bond markets and/or the European Fi-
The Re-emergence of Europe

The Financial Stability Facility (EFSF) has failed in both Greece and Ireland. It has provoked a surge in debt and as a result has made the country even more insolvent and the banks riskier (as an increasing amount of debt is on their books). Therefore, a programme of direct recapitalization (via preferred non-voting shares) of all the eurozone banks by the EFSF and its successor (the European Stability Mechanism – ESM) ought to be put in place.

- “An EU-wide system of deposit insurance needs to be created to avoid a run on the most fragile banks in the most fragile countries. This must be established at the same time as reducing moral hazard. This, in turn, entails an array of policy measures dealing with a range of issues, such as the ‘too-big-to-fail’ problem, an EU-wide system of supervision and regulation, the funding of the deposit insurance through appropriate bank levies, etc.

- “Debt mutualization – i.e. a eurobond of some kind – is needed to assuage the risk of a country leaving the eurozone, because European-wide deposit insurance cannot work alongside such a risk. Again, many different proposals exist. From a German perspective – the only one that matters since it is mainly Germany that opposes such an idea – the German Council of Economic Advisers’ proposal for a European Redemption Fund seems to be the most realistic. It is in effect a temporary programme that does not lead to permanent E-bonds; it is supported by appropriate collateral and seniority for the fund, and has strong conditionality.”57

As for a fiscal union, it is important, again, not to fall prey to the binary approach – the “everything-or-nothing” thinking that so often prevails and prevents the adoption of new ideas and solutions. Between no fiscal union of any kind and a full-fledged fiscal union à la Suisse or in the style of the United States, many possible intermediate solutions exist that would contribute to instilling much greater fiscal solidarity and discipline within the eurozone.

One such possibility might be to put in place a model that resembles the fiscal union found in the United States in the 19th century. In 1842, the US Senate rejected requests from some states for a financial bailout, thus establishing the principle of fiscal responsibility. At that time, the US political system combined sovereignty at the state level with fiscal responsibility in a community of equals. This voluntary model could work in the eurozone.58

It would work better than the current model that relies on Germany playing the role of dominant power enforcing fiscal discipline through political pressure. A rather more precise arrangement is needed that could bridge the two seemingly irreconcilable narratives of the creditor countries (that spendthrift governments will rob them of their savings) and the debtors (that austerity imposed by Europe’s hegemon is leading to the destruction of their social fabric). German Chancellor Angela Merkel and Federal Minister of Finance Wolfgang Schäuble,
among other leading German policy-makers, have implied the need for such a mechanism or “grand bargain”. In an opinion essay published in the *Financial Times*, Dennis J. Snower, the president of the Kiel Institute for the World Economy, has outlined the contours of such a plan. He sets out four broad measures, reproduced below:

First, each eurozone government would formulate a “stabilising fiscal rule”, specifying the long-run ratio of national debt to gross domestic product (not more than 60%), the convergence rate (how fast the debt ratio would reach its long-run value) and the counter-cyclicality of fiscal policy. The greater the fiscal stimulus permitted in recessions, the greater the fiscal contraction in booms. Such a fiscal rule could give debtor countries up to 25 years to get their house in order, as a substitute for temporary mutualisation of legacy debt. These countries could fight recessions with fiscal stimuli, avoiding the vicious cycle they are currently trapped in.

The fiscal rule, designed by each national government, would then be credibly implemented at eurozone level. If a government ran a deficit greater than permitted by the rule, the European Commission could, for example, be entitled to raise value added tax to bring the deficit down. If a country were unable to collect the requisite taxes, the commission would be entitled to help.

Second, the eurozone should adopt transparent criteria for sovereign solvency, so that a country whose national debt is too high relative to its performance (making it unable to reach a stable growth path while adhering to its fiscal rule) could be declared insolvent and submit to an orderly restructuring process.

Third, all eurozone countries would adopt a common system of financial regulation, including common supervision of banking and shadow banking systems, bank resolution, deposit insurance mechanisms, catastrophic loss insurance and incentives to avoid systemic risk.

Once all eurozone countries met their fiscal rules, the European Stability Mechanism could be restricted to support for financial institutions. Institutions that were not eligible for ESM financing would submit to the common debt restructuring and resolution regime.

Fourth, European structural funds should be targeted at investment to promote growth in countries with persistent current account deficits, with support from the European Investment Bank. This would make debtor countries more competitive.
With these measures in place, the European Central Bank could devote itself primarily to controlling inflation. Under the current regime, the risk of conflict between the ECB’s two goals – the stability of the financial system and price stability – raises fears of future inflation.

This grand bargain would give debtor countries the short-term support and latitude to overcome their problems, while assuring the creditor countries that the eurozone’s long-term path was sustainable.59

**KEY POINTS**

- Both a banking and fiscal union are needed to rebalance Europe
- A fiscal union requires a political union – this will take years and the process is fraught with uncertainties
- Progress towards a banking union can be achieved more rapidly but it needs to encompass supervision, resolution and bank deposit guarantees
4.4. Restoring Europe’s Competitiveness

Accelerating the reform process articulated through competitiveness-based strategies is a prerequisite to ensure that countries in the region get back to higher growth trajectories and to reduce the competitiveness divide that currently exists between northern and southern Europe. Building on more than 30 years of research, the Forum’s Global Competitiveness Reports provide a platform for dialogue between European institutions, business, civil society and governments on the areas requiring attention to improve Europe’s competitiveness.

As I have already discussed in the preceding section, in the European countries that currently constitute the greatest cause for concern (mostly the southern countries), the combination of low competitiveness and the resulting or related poor growth outlook makes the debt situation worse. Debt repayment, therefore, becomes increasingly difficult going forward. It is crucial and urgent for policy-makers to promote competitiveness-enhancing reforms and investments while at the same time engaging in short-term consolidation efforts. This is of course difficult because harsh fiscal constraints erode the ability to publicly invest in those areas most critical for competitiveness (education, health, infrastructure, and research and development).

So what are the solutions? Are there possible trade-offs?

As I set out in section 3.3, one of the most common elements that explains the current eurozone predicament is the persistent lack of competitiveness in the countries at the heart of the crisis, which prevents them from maintaining high levels of prosperity. Overall, low levels of productivity and competitiveness did not warrant the salaries that workers in southern Europe enjoyed, leading to unsustainable imbalances followed by high and rising unemployment. To put southern Europe back on a growth trajectory, a comprehensive package of measures to enhance competitiveness is required.

These measures should include:

1. Regaining financial stability by recognizing and resolving the weaknesses of the banking system and enhancing the financial liquidity of private consumers and enterprises

2. Regaining macroeconomic stability by ensuring fiscal discipline and undertaking structural reforms that can lower public spending in the medium to longer term
3. Introducing labour market reforms, fostering competition and entrepre-
neurship, and making more and better investments in growth-enhancing
areas such as education, technology and innovation.

I have discussed the first two measures in the preceding two sections. The
third pertains to competitiveness in the strict sense. Most of the policies they
encompass will only have positive impacts in the medium to longer run. How-
ever, all three sets of measures must be dealt with and adopted sooner rather
than later, as they are closely interrelated. Their effective implementation will
require strong political leadership so that a clear roadmap and efficient commu-
nication can be prepared to build social support for the reforms. Only then will
the economies of southern Europe find a sustainable exit out of the sovereign
debt crisis.

The EU is well aware of the need to jumpstart competitiveness in the region,
and its Europe 2020 Strategy is developed around three broad strategic axes:

- **Smart growth**: developing an economy based on knowledge and inno-
  vation

- **Sustainable growth**: promoting a more resource-efficient, greener and
  more competitive economy

- **Inclusive growth**: fostering a high employment economy delivering so-
  cial and territorial cohesion”

It identifies seven major initiatives the EU should take to drive growth and job
creation though increased competitiveness (some of them, such as youth em-
ployment, are analysed in greater detail later in this book):

- **Innovation Union** to improve framework conditions and access to fi-
  nance for research and innovation to ensure that innovative ideas can be
turned into products and services that create growth and jobs

- **Youth on the Move** to enhance the performance of education systems
  and facilitate the entry of young people into the labour market

- **A Digital Agenda for Europe** to speed up the roll-out of high-speed
  Internet and reap the benefits of a digital single market for households and
  firms

- **Resource-efficient Europe** to help decouple economic growth from
  the use of resources, support the shift towards a low-carbon economy,
increase the use of renewable energy sources, modernize the transport
  sector and promote energy efficiency
– “An Industrial Policy for the Globalization Era” to improve the business environment (notably for small and medium-sized enterprises) and to support the development of a strong and sustainable industrial base able to compete globally

– “An agenda for New Skills and Jobs” to modernize labour markets and empower people by developing their skills throughout the life cycle with a view to increase labour participation and better match labour supply and demand, including through labour mobility

– “European Platform against Poverty” to ensure social and territorial cohesion such that the benefits of growth and jobs are widely shared and people experiencing poverty and social exclusion are able to live in dignity and take an active part in society.”

As the European Council itself recognized in March 2012, progress on these seven fronts has so far been rather disappointing. The situation, however, is not hopeless. All southern European countries have adopted (or are in the process of implementing) a broad range of structural reforms that will markedly improve their performance in terms of competitiveness over the coming years. The attention of market participants and commentators is very focused on the fiscal consolidation measures needed to reduce public debt and has not always grasped the ambitious programme of reforms currently being undertaken. Structural measures cover:

– The progressive deregulation of the labour market, leading to much greater flexibility compared to the situation that has prevailed so far

– Many different decrees and legislative measures aimed at spurring competition, simplifying the administration and improving the business environment

– Practical steps and various initiatives destined to enhance research capabilities and to accelerate the development of innovation

– The liberalization programme of the services sector (particularly in Spain)

Our competitiveness analysis suggests that the divide between Europe’s northern and southern regions will progressively be reduced. Why? This is not a matter of hope over experience but stems rather from the very simple observation that most northern European countries are already positioned at the top of the competitiveness ranking while most southern countries – notably Greece – can be expected to engage in the convergence process from a low starting point, assuming that they move ahead in earnest with their articulated reform programmes. Therefore, I expect the gap to narrow.
Table 5: The Global Competitiveness Index 2012-2013 Rankings

<table>
<thead>
<tr>
<th>Country</th>
<th>Ranking (Out of 144)</th>
<th>Country</th>
<th>Ranking (Out of 144)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>3</td>
<td>Spain</td>
<td>36</td>
</tr>
<tr>
<td>Sweden</td>
<td>4</td>
<td>Poland</td>
<td>41</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5</td>
<td>Italy</td>
<td>42</td>
</tr>
<tr>
<td>Germany</td>
<td>6</td>
<td>Lithuania</td>
<td>45</td>
</tr>
<tr>
<td>United States</td>
<td>7</td>
<td>Malta</td>
<td>47</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>8</td>
<td>Brazil</td>
<td>48</td>
</tr>
<tr>
<td>Japan</td>
<td>10</td>
<td>Portugal</td>
<td>49</td>
</tr>
<tr>
<td>Denmark</td>
<td>12</td>
<td>Latvia</td>
<td>55</td>
</tr>
<tr>
<td>Austria</td>
<td>16</td>
<td>Slovenia</td>
<td>56</td>
</tr>
<tr>
<td>Belgium</td>
<td>17</td>
<td>India</td>
<td>59</td>
</tr>
<tr>
<td>France</td>
<td>21</td>
<td>Hungary</td>
<td>60</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>22</td>
<td>Bulgaria</td>
<td>62</td>
</tr>
<tr>
<td>Ireland</td>
<td>27</td>
<td>Slovak Republic</td>
<td>71</td>
</tr>
<tr>
<td>China</td>
<td>29</td>
<td>Romania</td>
<td>78</td>
</tr>
<tr>
<td>Estonia</td>
<td>34</td>
<td>Greece</td>
<td>96</td>
</tr>
</tbody>
</table>


As Table 5 shows, and as was already discussed in the section on the competitiveness divide, the countries of northern Europe are among the most competitive in the world. Three eurozone countries (Finland, the Netherlands and Germany) are in the top 10; they are even more competitive than the US. By contrast, the countries of southern Europe (those that suffer the most from the consequences of the competitiveness divide) are poorly ranked: Greece is in the 96th position, Portugal in the 49th, Italy in the 42nd and Spain in the 36th. As paradoxical as it may seem, their poor rankings are a cause for optimism. How can this be? These four countries have good chances of improving their competitiveness markedly because the structural reforms they are currently implementing are focused on those areas in which they are the weakest.

I shall illustrate this important point with a very simple observation. Southern European countries are poorly assessed (to varying degrees) on two pillars of the Global Competitiveness Index – institutions and labour market efficiency:

1. Institutions: the legal and administrative framework within which individuals, businesses and governments work together to generate wealth

2. Labour market efficiency: the flexibility in the labour market to move workers from one sector to another quickly and cheaply, and to support
wage fluctuations without too much social disruption, as well as the ability to use available talent efficiently.

Regarding the latter pillar, all four southern European countries have among the least efficient and least flexible labour markets in the world, as shown in Table 5.

**Table 6: The Global Competitiveness Index 2012-2013, Institutions and Labour Market Efficiency Pillars**

<table>
<thead>
<tr>
<th>Country</th>
<th>Institutions Rank out of 144</th>
<th>Labour Market Efficiency Rank out of 144</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>111</td>
<td>133</td>
</tr>
<tr>
<td>Italy</td>
<td>97</td>
<td>127</td>
</tr>
<tr>
<td>Portugal</td>
<td>46</td>
<td>123</td>
</tr>
<tr>
<td>Spain</td>
<td>48</td>
<td>108</td>
</tr>
</tbody>
</table>


What can be inferred from this? The severity of the crisis has forced the least competitive countries of Europe into action. After many years of procrastination, these countries are getting their act together by putting in place the structural reforms needed to address the issue of mediocre competitiveness. As a result, both their absolute performance and global ranking in these areas crucial for competitiveness have good chances to improve.

I have illustrated this phenomenon by referring to two important pillars of competitiveness, but the same logic applies to other areas, such as innovation, where efforts are also being made at both the national and European levels. It may be too early to cheer, but I sense that progress in terms of competitiveness is about to become reality.

Several observers have expressed their concerns that some of these reforms might be reversed as soon as the situation in these countries improves. I do not believe this will happen for two reasons:

1. Most of the policies that constitute a critical drag for competitiveness (particularly in the labour markets in terms of their inflexibility) were adopted in the 1960s and the 1970s. These were very specific times, both from historical and economic viewpoints: most European economies were booming while important concessions had to be made in terms of social policies to assuage the Communist Parties (very powerful in Italy and France, for
example) and the trade unions. Powerful vested interests had to be taken into account. These times are gone. Globalization has engulfed the world and every country understands it can no longer be an island. It is therefore hard to imagine what could drive a policy reversal for structural measures that are simply – and belatedly – adapting to the realities of today’s world.

2. Today, no political party or social organization of any major significance proposes to return to the previous state of affairs. The population of Europe is highly educated with good access to information. Many polls and surveys show that a majority of European citizens – particularly in southern Europe – appreciate the need for reform, despite the pain. At some stage, these reforms will eventually translate into higher economic growth. Why would the citizens of Italy, or Spain, or France, just to name these three, want to return to a system that they know full well put them into trouble in the first place?

Finally, an important point often seems to get lost or mischaracterized in the debate: there is no necessary trade-off between being competitive and ensuring the provision of key social goods. Indeed, the Nordic countries, all of which are among the world’s most competitive, demonstrate poignantly that it is quite possible to be entrepreneurial, flexible and agile, while providing a strong social safety net. This points to another important lesson: it is not the size of government – the amount of government spending – that matters but rather how those resources are spent for competitiveness.

KEY POINTS
- A large competitiveness gap exists between northern and southern Europe
- Progress on the seven fronts identified by the EU has been disappointing
- Critical reforms in the areas where southern Europe lags the most will eventually improve competitiveness
The culture of decision-making and the pervasive sense of distrust described in sections 3.5 and 3.6. have a perverse effect on European integration. At the moment, decision-making consists mainly of national politicians doing deals in committee rooms in Brussels. Naturally, they put their national interests first, not those of Europe. This will have to change.

After 60 years of European integration, now that it is on the cusp of disintegration, Europe can only move forward if Europeans share a sense of common purpose and see European institutions as effective and legitimate. The main problem with this is that the proposals intended to move the EU closer to a fiscal union or aimed at greater European integration in general are often perceived as a mere transfer of national parliamentary responsibilities to the European Commission (appointed by the governments) and to the intergovernmental Council of Europe. Vital progress pertaining to the EU’s internal market in the areas that remain hopelessly fragmented (energy, digital markets and the services sector) has been prevented by national concerns and vested interests.

Meanwhile, the power of the only democratically elected institution, the European Parliament, is rather limited. It cannot initiate legislation and it shares power with the Commission and the Council in adopting new legal rules. Furthermore, the turnout for its elections is rather low. In fact, the average turnout has declined with every single vote since direct elections began in 1979.

The European Parliament has not yet provided the legitimacy needed to address the perception of a democratic deficit. Closing this deficit would require much stronger ties between national parliaments and European institutions.

Many ideas and proposals have been put forward about how this ought to be done. The German philosopher Jürgen Habermas, for example, has suggested that members of the European Parliament hold seats simultaneously in their respective national parliaments. Peter Sutherland, a former European commissioner from Ireland, has proposed two essential measures to remedy the situation.

1. Democratic selection by election of the president of the Commission combined with further steps to legitimate nationally each of the commissioners to be appointed by him (or her)

2. Greater engagement by national parliaments in the deliberations of their representatives at the Council of Ministers on proposals for legislation made by the Commission
In a joint editorial published in the international media, two European ministers of foreign affairs, Radek Sikorski of Poland and Guido Westerwelle of Germany, proposed a range of measures that converge with those above (two of which pertain to the current institutional set-up). They are quoted here:

1. “to strengthen the European Parliament and the involvement of national parliaments. Creating a permanent joint committee between the European and national parliaments could serve that purpose”

2. to create “a streamlined and efficient system for the separation of powers. [Europe] also needs a directly elected European Commission president who personally appoints the members of his ‘European Government,’ a European Parliament with the powers to initiate legislation and a second chamber for member states.”

KEY POINTS

- EU decision-making is dominated by national politics – this must change
- The role and legitimacy of the European Parliament must be strengthened
- The European Commission may require a president who is directly elected
Many years ago, Raymond Barre, who was then French prime minister, told me in a private conversation: “In one generation, you will not be offered a job; you’ll have to create your own job”. How prescient he was!

Today, Europe’s young people face being a lost generation living through a lost decade. The expression “lost decade” was originally used in referring to Latin America in the 1980s and then Japan in the 1990s. “Lost generation” is an expression originally credited to Gertrude Stein to describe those who came of age during World War I. It is now used to depict a generation of young people blighted by unemployment with little hope of a better future.

To a large extent, European youth are plagued by concerns that their future has been thrown into reverse. Their trajectory, in contrast to that of their parents and grandparents, is defined not by hope but fear. Youth unemployment is indeed one of Europe’s most serious issues, one that should not be underestimated. Despite the frightening speed at which young people have been expelled from the labour market, it is important to note that Europe has coped with high youth unemployment for many years. In several countries, particularly in southern Europe, the increase in unemployment among youths appears to be a regression to the mean caused by the crisis, as shown in Figure 13.

**Figure 13: Youth Unemployment Rates, 1980-2010 (%)**
According to media reports, Europe is one of the worst regions in the world for youth unemployment. It currently stands at about 20%, with huge disparities by country. In Spain, half of those under 25 are officially unemployed! The International Labour Organization has warned that the eurozone risks losing a further 4.5 million jobs over the next four years, primarily among young people, unless it makes a concerted policy shift towards job creation.66 This is of course where politics and economics meet, as youth unemployment is a potent source of social and political instability.

Unemployment estimates, particularly for youth, can be deeply misleading, however. The shocking numbers one hears every day – that youth unemployment is nearing 50% in Spain and Greece, for example – are methodologically flawed in that they make the situation seem far worse than it is. That is because in calculating youth unemployment, the number of unemployed youth (the numerator) is divided by an artificially small denominator because the young people who attend university or vocational training programmes are not considered part of the labour force because they are not looking for a job. Paradoxically then, the higher the number of young people going to university, the greater the rate of youth unemployment!

A far better indicator is the youth unemployment ratio, which expresses the number of unemployed youth relative to the total population aged 16 to 24. As Table 6 shows, youth unemployment ratios are much lower than youth unemployment rates. A ratio of 13% is of course much too high, but it is nowhere near the 40-50% that would almost automatically trigger a social explosion. While 10% or 13% are still very high numbers, with real people lying behind the statistics, they paint perhaps not such a stark picture as the dreadful 40-50% most often mentioned by the media. In fact, the situation with respect to youth unemployment appears to be worse in the US than it is on average in Europe.67

In southern Europe, one phenomenon serves as a shock absorber that makes an awful situation slightly less awful than it may seem: the boomerang generation. This refers to young people aged between 25 and 34 who live with their parents. Especially for unmarried children, this is a common and widely accepted social custom in southern Europe, where the inter-generational social bond is much stronger than in other parts of the world. The boomerang trend is closely correlated to the economic situation, particularly in the labour market: as youth unemployment rises, the ratio of boomeranging individuals increases as well. Today, it is estimated that 70% of Italian men who are 25 to 34 years of age are mammoni – living with their mothers. The figures in Spain are roughly the same.
Nonetheless, the poor job outlook for youth in many eurozone countries, and particularly in southern Europe, remains one of the most serious concerns...
facing policy-makers. It has a negative fiscal impact of course but most importantly a very negative and even devastating effect on the lifetime earnings and career paths of affected young people. In economic jargon, this is the so-called scarring effect.

So what can be done? The remedies are known, but most will take time before they translate into a reduction in youth unemployment because they often entail major structural changes in the education system. They generally include: (1) higher participation in career guidance programmes for youth still in school, (2) better career and labour market information for young job seekers, (3) the promotion of a more positive image of vocational education, (4) better training, and (5) investment in entrepreneurship education.68

The reason Germany has the lowest rate of youth unemployment among all Organisation for Economic Co-operation and Development (OECD) countries is probably due to the importance of vocational education and the relentless focus on training. Going further, the greatest asset a country can invest in is undoubtedly education. In today’s world, talent – in many respects, a by-product of education – is what ultimately makes the difference. The World Economic Forum Competitiveness studies, to which I have abundantly referred, make this very clear. Four of the 12 pillars that determine competitiveness relate directly to education: the fourth – health and primary education; the fifth – higher education and training; the ninth – technological readiness; and the twelfth and last pillar – innovation. To some extent, all the others also depend on the quality of human capital – and therefore education – that underpins them.

As Europe is falling behind other parts of the world in its competitiveness, much more needs to be done in terms of innovation and entrepreneurship. Europe’s knowledge base has to be linked with the structures of production so that existing sectors can be transformed. Education reforms in the meantime should be relentlessly pursued. Put simply, Europe has to invest heavily in the growth sectors of the future. This can only be done by strengthening research and innovation throughout the EU.

The next few years will be characterized by tremendous technological innovation related to progress in such areas as genetics, nanotechnology and particularly digitalization. The full impact of this disintermediation will go far beyond the publishing and media sectors and will revolutionize healthcare, education, transportation, and so on. This means many traditional professions will slowly disappear. The danger for Europe, which has a preservation mentality and is also under pressure from the trade unions, is to do everything to keep dying sectors alive.

The only way to really confront the innovation trap is to nurture new and evolving industrial opportunities. This is an urgent priority since the competitive landscape will completely change, with countries such as Brazil, China, India,
Mexico and Turkey all trying to move up the value chain and become formidable competitors in tomorrow’s technologies. Economic as well as political power in the future will be determined less by the size of a country and much more by its technological superiority.

What makes me confident about the future is that there are many initiatives whose purpose is to foster a culture of entrepreneurship. Sadly, too many of these programmes are often launched at the national rather than at the European level. One such pan-European idea, put forward by StartUp Europe, a collaboration between Telefónica, the Spanish telecom multinational, and the Lisbon Council, a think tank based in Brussels, is to fast track the creation of hubs of innovation that will encourage the entrepreneurial spirit across Europe and help the region regain its leadership in technology and innovation. The more these kinds of initiatives, the greater the hopes for Europe.

KEY POINTS
- Youth unemployment is one the curses of Europe
- European youth unemployment levels are much too high but not as high as commonly reported or believed
- Instilling a culture of entrepreneurship is a must for the long-term reduction of youth unemployment
4.7. Nurturing an Ideal and Rebuilding a Global Brand

At the moment, Europe seems deeply divided again. It lacks an attention-grabbing project that can propel the European ideal forward. Why is that so? Apart from the obvious corrosive effect of the crisis, human beings have an innate tendency to consider as a given what has been achieved, often with great hardship. The historian Timothy Garton Ash captured this frame of mind eloquently when he wrote that “young Europeans from Portugal to Estonia and from Finland to Greece came to take peace, freedom, prosperity and social security for granted.” He added: “Now, with the current crisis still unresolved, Europe lacks most of the motivating forces that once propelled it toward unity.”

Where are these motivating forces to be found?

Without obsessing on the past, it is critical to remember again and again Europe’s many successes over past decades. The idea of consolidating these gains and pushing them further can (and should) be a powerful source of motivation. As Amartya Sen and many others have pointed out, the major achievements include “the emergence of the European Union, the reunification of Germany, the extension of democracy to Eastern Europe, the consolidation and improvement of national health services and of the welfare state, and the legalization and enforcement of some human rights.”

Each of these was no small feat, especially when considered against the background of what has happened in the rest of the world where many of the same standards do not apply! And in another positive twist, these accomplishments occurred in the context of a European economy that had been destroyed and needed to quickly rebuild and develop its industrial capacity and infrastructure after World War II.

Today, it is possible to coalesce the European ideal around the consolidation and expansion of these multiple achievements, and also around the diversity of Europe – an incredible source of richness in a world defined by interdependence. Sceptics argue that Europe cannot organize itself politically, let alone survive as a homogeneous entity, because it is too large and too diverse. But neither of these two objections is valid. India is larger, yet on many counts it is more diverse culturally, linguistically and ethnically than is Europe. As remarked in a major essay on “Nationalism” by India’s national poet and 1913 Nobel Prize in Literature laureate, Rabindranath Tagore: “…India has all along been trying experiments in evolving a social unity within which all the different peoples could be held together, yet fully enjoying the freedom of maintaining their own differences. The tie has been as loose as possible, yet as close as the
circumstances permitted. This has produced something like a United States of a social federation...”71 In Europe itself, many successful countries comprise diverse multilingual entities as Belgium, Finland and Switzerland do, or have a variety of religious traditions as in Germany. Obviously, diversity does not prevent political stability.

Many of the values that Europeans favour may be more greatly embodied in the EU than in most other countries around the world. According to a Special Eurobarometer survey requested by the European Commission and conducted in December 2011 across all 27 EU countries, Europeans see freedom of opinion (64%), peace (63%), social equality and solidarity (61%), tolerance and openness to others (56%), respect for nature and the environment (55%) and respect for history and its lessons (52%) as values that matter and that are best represented in the EU.72

The power to explain and convince is paramount, even more so in a situation where the economic costs and political strains of the crisis are provoking a “re-nationalization” of public opinion across the continent. Candour matters considerably, and politicians need to speak the truth and walk the talk. The world is undergoing radical transformation. In Europe in particular, the definition of the social contract is being rewritten. The welfare state in countries ranging from France to Greece is a notion about to become extinct. Its extreme generosity will have to give way to something that much more resembles the Nordic model, where the principles of inclusivity and redistribution coexist with a model that favours adaptation and flexibility. Policy-makers who are implementing painful adjustments need to provide a credible long-term narrative with respect to the European Union and the eurozone, a vision for reform that voters can not only understand and accept but also embrace. Political leaders must prepare the population for what lies ahead. It is not that preparation alleviates the pain caused by the crisis, but it does help people adjust gradually to the idea that the world of tomorrow will be much different from the one of yesterday. Until now, too many European governments have been in denial about the real nature of the crisis, emphasizing its temporary nature (“soon, things will return to normal”) and underestimating the true cost of the adjustment. This attitude can only exacerbate voters’ frustration and intensify the risk of populism.

Europe is currently at the beginning of a process that will lead to further economic and political integration. All eurozone members have already agreed to embark on a road with more integrated financial sectors, fiscal and economic policies and democratic decision-making. These entail a quantum leap that the European Union has never dared to take before: sovereignty will progressively be transferred from individual countries to the supranational level, which will in turn require constitutional amendments and, in some countries, a referendum. There is zero chance of success if European leaders do not succeed in explaining to their electorates why this makes sense, why this is an idea worth fighting for.
As human beings, we dislike change for it always requires adaptation. The narrative about Europe needs to move beyond the current fear of implosion. Most importantly, it needs to be truly inspiring and aspirational. Until now, and more often than not, the main argument of European leaders about their proposed economic policies could be summarized as follows: “We need to implement changes that are sadly going to inflict more pain in the short term, to ensure that future losses in the quality of life and social benefits are smaller than they would be otherwise.” How can European citizens find hope and be motivated with such a negatively charged message?

The new narrative has to highlight the gains of integration by explaining in simple terms why the benefits of the euro outweigh the costs of undoing it and, most importantly, why European integration is essential to enhance the well-being, economic stability and standing in the world of each of the EU member states. Concretely, this means:

- explaining reforms before elections and providing a compelling argument to voters
- reinventing the language of Brussels and redefining and explaining to citizens why Europe is worth fighting for
- having a clear vision in terms of coherence between policy areas
- sharing best practices for reform and extracting good ideas
- allowing for the wider participation of European citizens

In the global context, European countries can only maintain their values and act successfully in their interests if they are united and project an image of cohesiveness. This can be achieved by much greater coherence in the EU’s external actions. A document endorsed by several EU foreign ministers outlines some of the critical measures that can be undertaken for that purpose. Among the recommendations:

- Encourage the high representative to play the role of coordinator of external affairs within the European Commission
- Set a clear mechanism for how the high representative, vice-president and other commissioners should cooperate in conducting Europe’s external affairs
- Bolster the Common Security and Defence Policy (CSDP)
- Shape a proper European Defence Policy with a cooperative approach to the defence industry such as the setting up of a single market for weapons projects
– Strengthen the integrity of the borders of the Schengen area by establishing a European border police and launching a European visa in the medium term

– Build an internal energy market by developing a European infrastructure for energy, enhance energy efficiency and set a joint approach to external action on energy.74

On a broader level, one should not underestimate the power of a positive narrative – storytelling is part of our human DNA, and it is impossible to win an argument or be convincing without it. Europe’s leaders cannot surmount the crisis with only demands for austerity. They must inspire and create a vision of real, tangible rewards that will come alongside a reformed EU.

KEY POINTS
– Politicians need to speak the truth about the real cost of adjustment
– Policy-makers and opinion-shapers need to provide a long-term, credible narrative about Europe
– Greater coherence is essential in the EU’s external actions
4.8. Progress?

At the time of writing (the end of October 2012), hopes about the future of the eurozone are at best uncertain and undeniably low. To put it simply, the consensus view in the financial markets, shared by many business leaders and opinion-makers, is that the ECB president’s announcement on 6 September that the central bank will act as a lender of last resort has bought some time, giving politicians breathing space for urgently required follow-up supportive action, despite being perceived as lacking in courage and leadership and procrastinating about reforms. The market rally that took place in the summer of 2012 reflected this weakness and negativism. Prices went up by default only because the overall situation in Europe was then perceived as less bad than feared, even if unlikely to get any better. Only one thing seems certain: politics will ultimately determine the future of the eurozone.

Even so, we should not lose sight of a general, if slight, improvement in economic fundamentals. Some scepticism about the sustainability of the relative improvement in the eurozone may prevail, but the truth is that internal adjustment or internal devaluation (the adjustment mechanism that has to take place when the currency depreciation “toolkit” is not available) is somehow working, even if an improvement in growth has not followed.

The first stage of the internal devaluation process consists of the contraction of real domestic demand (GDP minus net trade receipts) relative to other countries. Little by little, spending moves back in line with income, causing the deficit to shrink. In most of southern Europe, this has entailed a reduction in labour costs, which have adjusted dramatically. As illustrated in Figure 14, relative unit labour costs, which correspond to wages adjusted for productivity, have fallen sharply in Ireland and Greece, and are on a downward trend in Spain and Portugal.
Consequently, countries such as Ireland, Portugal and Spain have experienced a generally strong performance in exports and are now registering a current-account surplus (the positive difference between a country’s total income and its total outflows). Amazingly, Irish, Portuguese and Spanish export growth has not only kept pace with Germany’s in recent years but has outperformed the UK’s.

As Figure 15 demonstrates, Ireland is running a current-account surplus of a similar size to that of Germany in terms of GDP ratio. Portugal has also moved in the same direction, having run a current-account surplus of 2% of GDP in the three months leading up to July 2012. Spain also recorded a small current-account surplus in July 2012 (equivalent to 500 million euros), a remarkable improvement considering that its deficit amounted to more than 10% of GDP in 2008. Sadly, Greece remains the only eurozone country that continues to run a sizeable deficit (more than 4% of GDP) although this has significantly diminished over the last year.
This general improvement in the current-account position is a critical step in the whole adjustment process. It is also encouraging in terms of what may come next. The successful examples of the Baltic countries – Estonia, Latvia and Lithuania – which were subject to deep balance of payment crises, show that when a country moves back into a current-account surplus, the downward pressure on demand normally starts to ease, progressively leading to the stabilization of unemployment as the economy becomes self-financing.

Figure 16 shows that current-account imbalances should continue to narrow within the eurozone, reflecting not only a collapse of demand among the deficit economies in the periphery but also an improvement in their export performance. Further reductions will require more policy changes. In external-deficit countries, this means the continued reduction of their large fiscal deficits, slower entitlement or benefits spending, and reforms in the labour market. In surplus countries, various policies should focus on an increase in domestic consumption.
All in all, various improvements in deficit countries are positive steps in the right direction. They correspond to the narrow, technical definition of competitiveness that has an immediate bearing on current-account positions through an improvement in the net trade position of southern European countries. However, only structural reforms as defined in the Global Competitiveness Index will improve sustainable long-term economic growth.

But what happens next? Because of the recession now engulfing most of the eurozone, internal consumption in the eurozone as a whole is bound to remain weak for some time, suggesting that any sustainable upturn can only be export-led. Such improvement rests on two premises: (1) a much weaker euro due to a substantial depreciation against other currencies, most notably the US dollar, and (2) significant improvement in the global economic outlook.

It is not the purpose of this book to elaborate on these two dimensions, but suffice it to say that neither should be taken for granted in the foreseeable future – far from it. First, a depreciation of the euro is contingent upon other
countries accepting that their currency should appreciate against the eurozone currency. This is doubtful in the context of the currency wars currently being fought around the world.\textsuperscript{75} It is true that almost all countries around the globe are currently seeking a weaker currency. Second, improvement in the global economic outlook is contingent upon substantial upturns in the three powerhouses: the eurozone, the US and China.

The good economic fortune of Europe, therefore, depends to a large extent on what happens next in the US and China. The latter is decelerating quite sharply. In the former, the upturn is real but growth is likely to remain quite sluggish for a prolonged period of time. The critical point I wish to convey here is quite simple: the international ecosystem is completely concatenated, or linked together by multiple channels. This suggests that, despite its very best efforts, Europe cannot succeed alone: its fate and that of its trade and financial partners are very much intertwined.

In terms of what has been done so far within the eurozone, the observations above demonstrate that the adjustment in terms of flow through current-account balances is under way, and quite successfully so. What remains to be done is an adjustment in terms of stock (the national debts). The two forms of adjustment (stock and flow) are completely linked, which tends to create the “doom loops” I have already referred to in this book. This adverse feedback mechanism works as follows: as the required adjustment in current-account balances tends to depress GDP growth, the stock of debt in terms of size relative to GDP increases. This, in turn, compels investors to demand a higher risk premium to roll over existing debt. As a result, the costs for servicing the debt increase, which can lead to a deterioration of the current-account position, thus closing the first round of the feedback loop. That is what deleveraging is all about – a problem potentially as acute in Japan, the US and the United Kingdom as it is in the eurozone.

Greece, Ireland, Portugal and Spain in particular possess large stocks of debt owed to foreigners that need to be worked off in the future. Most likely, further debt restructuring will be required.

**KEY POINTS**

- Southern Europe is showing slight improvement in its economic fundamentals
- All southern European countries have improved their current-account position
- An adjustment in terms of stock (levels of national debt) must still be made
5. CONCLUSION

The dilemma currently facing Europe was elegantly captured in an op-ed written by the Financial Times commentator Martin Wolf in February 2012: “The eurozone is in a form of limbo: it is neither so deeply integrated that break-up is inconceivable, nor so lightly integrated that break-up is tolerable. Indeed, the most powerful guarantee of its survival is the costs of breaking it up. ... Yet if the eurozone is to be more than a grim marriage sustained by the frightening costs of dividing up assets and liabilities, it has to be built on something vastly more positive than that.”76

What could this be? And what will the result be?

The community of experts is deeply divided about Europe’s outcome in general and about the eurozone in particular. At one end of the spectrum, economists like Martin Feldstein proclaim the euro is already dead while, at the other end, equally competent economists argue that the euro will not only survive, it will emerge much stronger from the crisis.77 What is at stake criss-crosses so many different disciplines and so many different interests that even experts, normally not shy about pronouncing definite judgements, find it hard, if not impossible, to agree on the essentials.

An expert panel of several dozen of the brightest economists in the world conducted by the University of Chicago illustrates this point. In September 2012, the group was asked several questions pertaining to the economic future of Europe and the role that past policy-measures might have played. The results display an amazing dispersion around the average, with a very low percentage of strong convictions, a high percentage of economists confessing that they did not know (slightly less than one-fifth had no opinion), and an equal number of economists agreeing or disagreeing with the proposal.78

In conditions of such phenomenal uncertainty, who should be believed? The simple truth is that nobody knows, not even the people in charge of the issue at the highest level of responsibility – the political leaders of Europe. Confessing uncertainty does not sell well to the public, but forecasters must come to terms with the fact that they are dealing with a socio-economic and political system that is non-linear and adaptive. Contrary to physical systems whose components are independent of each other, a complex living system changes and adapts all the time. Its components interact together in non-simple ways often characterized by an absence of visible causal links, which makes them impossible to predict. In the case of Europe, a myriad of economic, political, societal,
financial, diplomatic, security and other considerations intersecting with each other in surprising and unexpected ways are being dealt with.

In light of this, my prudent prognosis for Europe is the following: Europe will survive and its currency – the euro – will remain intact, even if in a truncated form (if just one country were to exit, for example). After a crisis of several years (possibly up to 10), European momentum will begin to grow again and will even surprise us positively, I believe. Why is that my conviction? As I have shown in this book, the process of integration has been the bedrock of European politics for now more than 50 years. Most politicians have invested a considerable amount of political capital in moving it forward – a fact that many market participants often forget or decide to ignore. For policy-makers, the failure of the euro equals the failure of Europe. “If the euro fails, Europe fails,” German Chancellor Merkel said in the Bundestag in 2011.79 This explains their determination to prevent it from happening.

Yet failures do occur. They are a regular occurrence in world affairs. What might trigger a disintegration of the eurozone? The plurality of risks to which I have already alluded in several parts of this book can be grouped into three broad categories:

1. **Political and societal backlash**: A risk exists that some governments may either fall or be influenced by the rise in populism and nationalism. In creditor countries, populist parties from the extreme right are trying to capitalize on the resentment provoked by the perceived folly of debtor nations. In debtor countries, populism fuelled by both the extreme right and extreme left is directed against the austerity imposed by creditor countries. As continued austerity is a given (both in creditor and debtor nations, but with varying degrees of intensity), the risk of a popular backlash is real and mounting. Recent research shows unambiguously that austerity and social instability go hand-in-hand.80

2. **Policy miscalculations**: The risk of a country’s refusal to sacrifice part of its sovereignty and the barriers to changes that are required to move towards a greater union are substantial. They include possible referenda, parliamentary majorities and the support of constitutional courts. Some countries may fail to ratify the reforms they approved or may even withdraw from them later. Doing so would force them to be excluded from the formal governance structures that govern the functioning of the EU.

3. **Capital flight and bank runs**: Since the beginning of the crisis, approximately 16.2 trillion euros in deposits have been withdrawn – mostly by southern European households – from savings accounts.81 This corresponds to local consumers’ assessment of the likelihood their country will exit from the eurozone. Like all psychological phenomena, it cannot be forecast, let alone assigned a subjective probability. Two things
(an observation and a fact) give me, however, some degree of confidence. First, a bank run has not happened yet, even in Greece during the acute episodes of the crisis. Second, October 2012 was the first month during which withdrawals did not increase in aggregate. Might this trend be slowing?

In this ocean of uncertainty, my only two reasonable convictions are the following:

1. The process leading to further European integration will be arduous and painful, marked by many discontinuities, which will leave in their wake a great deal of turbulence and volatility.

2. In this process, Germany will increasingly occupy a central position. For the first time in the history of the EU, Germany is – whether willing or not – the unquestioned leader. Ironically, this may create a rise in anti-German feeling in some parts of Europe.

For true leaders, deep crises, like the one currently afflicting Europe, provide extraordinary opportunities for bold decisions and courageous institutional measures. It is often said that, despite its many and obvious positive attributes, democracy in times of stress tends to lead to inaction or inertia. This does not have to be the case: powerful adverse shock can force reforms. Quite simply, the worse the situation gets, the greater the determination should be to change things.

Europe’s traditional preservation mentality must give way to a willingness to allow a healthy period of creative destruction. In other words, to create a better and more viable Europe that is still founded on the same social values and freedoms as before, we must consider destroying part of what we built over the decades since the end of World War II. This will have to include some of the social safety nets that are considered by many to be their birthright. In medicine, it is sometimes necessary to break down or kill damaged or diseased cells to improve the health of the patient. For sustained growth and a more prosperous Europe, we must be willing to take the pain to reap the enormous potential gains. In the same way that the human eye evolved from its crude construction in early man through incremental changes to the complex and crucial instruments of vision that we each possess today, so too will the European Union work out its imperfections and progress to a stronger and more sustainable system with clear purpose and benefits.

There is no doubt that the excesses, which are now being redressed, have undermined the European social model. But those apocalyptic soothsayers who predict Europe’s demise tend to forget that the continent is endowed with two precious assets that are critical to its long-term success: (1) a high-level of education, which results in what economists call a good “stock of human
capital”, and (2) good quality – on average – governance (no country in Europe does not allow the exercise of an individual’s property rights).

In a world that is evolving very fast and radically, and in which mankind will experience a succession of disruptive changes caused by demographics (ageing in particular), climate change, the rise in social inequities, resource scarcity, and so on, these two assets matter more and more. Importantly, they cannot be taken away. In such a context, any long-term vision for the world must be based on a combination of environmental sustainability, and quality and dignity of life. These are all areas in which Europe possesses a strong comparative advantage. But Europe’s model needs to evolve towards something that resembles more its Scandinavian counterpart, in which the values of entrepreneurship happily coexist with those of sustainability, solidarity and inclusion.

I conclude with the following thought: when reflecting on the future, it is important to realize that no situation is ever set in stone. Today, very few Europeans remember that before becoming the engine of Europe, Germany was portrayed in the late 1990s as Europe’s sick man. Germany only became the European powerhouse that it is today by acting early and decisively with the launch of important reforms in its welfare system. It did so much earlier than any other European state. These efforts have paid off, combining effectively, and much better than in many other countries, economic dynamism with social cohesion.

There are no structural, cultural or political reasons why Germany’s example of taking the bull by the horns cannot be emulated by other European countries. Despite the social and economic pain inflicted by the crisis, abundant evidence shows that reforms are proceeding, maybe not as fast as some would like, but proceeding nonetheless. In terms of the social acceptability of reforms, particularly in southern Europe, I believe that a turning point has been passed. No doubt the road is going to be very bumpy but from now on, I would venture that there are more likely to be surprises in Europe in general, and the eurozone in particular, on the upside rather than on the downside.

Europe’s history over the last few years can be characterized as a constant process of going two steps forward and being forced one step back. That is also the case currently, during this very critical juncture. Not only the survival of Europe is at stake. Europe has a symbolic meaning for the whole world, as recognized by its receiving the 2012 Nobel Peace Prize. The world will in general become more diverse, complex and yet fully interdependent. Europe to a certain extent is a symbol and the prototype for living peacefully together despite many contradictions and occasional opposing interests. The European idea constitutes hope not only for this old continent but ultimately for human-kind as a whole.

**Klaus Schwab**

**Cologny, 27 October 2012**
NOTES


8. The full text of the speech, delivered in Zurich on 19 September 1946, is at: http://www.churchill-society-london.org.uk/astonish.html. In the
final paragraphs of the speech, comments by Churchill suggest that he did not envisage the participation of Britain in the United States of Europe.


10. For the full text of the Schuman Declaration of 9 May 1950, see the European Union website: [http://europa.eu/about-eu/basic-information/symbols/europe-day/schuman-declaration/index_en.htm](http://europa.eu/about-eu/basic-information/symbols/europe-day/schuman-declaration/index_en.htm).

11. As noted on the official website of the Nobel Prize: [http://www.nobelprize.org/alfred_nobel/will/short_testamente.html](http://www.nobelprize.org/alfred_nobel/will/short_testamente.html).


15. Thomas Mann, Speech at the University of Hamburg, 1953.


22. Put forward by the economist Robert Mundell in 1961, the theory of the “optimal currency area” (OCA) looks at whether a geographical region can maximize economic efficiency by sharing a single currency. It states that four criteria are needed for an OCA to succeed: (1) labour mobility, (2) openness with capital mobility and price and wage flexibility, (3) risk-sharing such as an automatic fiscal transfer mechanism, and (4) similar business cycles.


30. This is easier to understand with a practical example. Let us assume that a French importer places an order with a German company that exports machinery. Payments to and from the accounts of the buyer and seller will be channelled via central banks. The German exporter's bank receives a credit with the Bundesbank, which in turn has a claim on the ECB. The French importer's bank owes its local central bank, leaving the Banque de France with a debit at the ECB.

31. Martin Wolf explains why in the following example. Suppose that owners of a Spanish bank account transfer money to a German bank. This will increase the liabilities of the Spanish central bank and the assets of the Bundesbank, inside the eurosystem (TARGET2). Meanwhile, the German bank will have a liability to the Spanish depositor and a reserve position at the Bundesbank. Germany’s net position will be unchanged: the net claims of the Bundesbank will rise, while those of Germany’s private sector will shrink. Martin Wolf, “Why Exit Is an Option for Germany”, *Financial Times*, 25 September 2012. [http://www.ft.com/intl/cms/s/0/1e2f2cd0-064e-11e2-bd29-00144feabdc0.html#axzz27MTDOMiQ](http://www.ft.com/intl/cms/s/0/1e2f2cd0-064e-11e2-bd29-00144feabdc0.html#axzz27MTDOMiQ).


35. See http://www.weforum.org/reports-results?fq=report%5Ereport_type%3A%22Competitiveness%22%5Esocial%3A%22Competitiveness%22.


42. As quoted in: Giles Merritt, “Where is Europe’s Foreign Policy?” Project Syndicate, 26 July 2011. [http://www.project-syndicate.org/commentary/where-is-europe-s-foreign-policy-](http://www.project-syndicate.org/commentary/where-is-europe-s-foreign-policy-).


50. Ibid.


52. Ibid.


54. This is a critical point, which a former member of the ECB’s Banking Supervision Committee has made in an editorial: David Green, “Be prudent with eurozone banking rules”, Financial Times, 18 October 2012. http://www.ft.com/intl/cms/s/0/51718232-179c-11e2-8cbe-00144feabdc0.html#axzz29dfqvdE.


To put this into historical perspective, the sharp indebtedness of American states followed the incredible success of the Erie Canal’s construction in the 1830s. Alasdair Roberts, professor of Law and Public Policy at Suffolk University Law School in Boston, has documented and analysed this period in US economic history: “In subsequent years, most American states started to borrow massive amounts of money to finance their own canal and railroad expansion. The loans took the form of bonds issued primarily to British and other European investors. In most cases, the interest payments alone on these bonds were close to the annual revenues of these states, but they were convinced that the revenues from expanded business activity would pay for the debt, as it had for the Erie Canal. Eventually, the inevitable happened and the states began to default. By 1840, nine different governments (including Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, Pennsylvania, and the territory of Florida), responsible for two-thirds of all American government debt held privately, missed interest payments, attempted to sidestep creditors or flatly repudiated their obligations.”


61. The theme of Innovation Union was explored in depth in: “Position paper of the European Research Area and Innovation Board (ERIAB): ‘Stress-test’ of the Innovation Union”.


This editorial is derived from the “Final Report of the Future of Europe Group,” endorsed by the foreign ministers of Austria, Belgium, Denmark, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Portugal and Spain. It can be found at http://www.auswaertiges-amt.de/cae/servlet/contentblob/626322/publicationFile/171784/120918-Abschlussbericht-Zukunftsgruppe.pdf.


68. World Economic Forum and Manpower Group, Youth Unemployment Challenges and Solutions: What Business Can


73. These practical recommendations were made in a session on “Galvanizing Support for Reform” at a World Economic Forum meeting on “Rebuilding Europe’s Competitiveness” that took place in Rome on 30 October 2012.


75. The expression “currency war” was initially coined by Brazilian Minister of Finance Guido Mantega in 2010.

76. Martin Wolf, “Much too much ado about Greece”, *Financial Times*, 14 February 2012. [http://www.ft.com/intl/cms/s/0/3d4c2598-5701-11e1-be5e-00144feabd0c0.html#axzz2BAfna9Jw](http://www.ft.com/intl/cms/s/0/3d4c2598-5701-11e1-be5e-00144feabd0c0.html#axzz2BAfna9Jw).

77. C. Fred Bergsten and Jacob Funk Kirkegaard, “The Coming Resolution of the European Crisis: An Update”, Peterson Institute for International


