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The Future of the Eurozone: Outlook and Lessons

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Chairwoman Shaheen, Ranking Member Barrasso, members of the Subcommittee, I am honored to appear before you today to speak about the evolving crisis in the eurozone. Since both my colleagues are accomplished economists, I will let them address the economics of the crisis, and will focus my remarks on the political aspects, including the lessons learned and the ramifications for the future, both for Europe and for transatlantic relations.

I believe this crisis is as much about politics as it is about economics. Its origins are to be found in a political failure to establish credible governance for economic and monetary policy, and European leaders have dealt with the crisis through a series of decisions about political power rather than economic measures. In the end, the crisis will continue for some time to come — not just months, but at least a year and probably two— and will be resolved only when the governments agree on who has the power to set economic and monetary policy in the eurozone.

The euro, just like the European Union itself, all the way back to the European Coal and Steel Community, was an economic initiative designed primarily to achieve a political purpose. It was less about the creation of a currency based on economic demand, but rather about taking another step towards "ever closer Union." At the time, many economists expressed skepticism, especially given the different approaches to monetary policy within the eurozone, but the politicians went ahead. And the euro has been a tremendous political success, as an important symbol of European integration, and rising significantly against the dollar during its lifetime. The current crisis is the reckoning, however, for Europe's failure to establish effective governance when the euro was created.

Throughout the crisis, European governments have been unable to respond to market pressures because the eurozone has lacked the right mechanisms and institutions. During the last two years, European leaders have instead focused on creating those mechanisms and institutions. They have taken significant strides, including: adopting a “six pack” of measures establishing European level budget oversight, a fiscal compact that requires national balanced budget amendments; and most recently deciding to undertake European level supervision of major banks, a step which may lead to an eventual banking union. But progress has been slow and incremental, some would say torturous. This is my first lesson from the crisis: EU decision-making is difficult and will remain so. We will not wake up any day soon and find the eurozone crisis solved. Because of the difficulties of reaching decisions among the 27 members, muddling through is likely to be the optimal policy choice.

My second lesson is that European decision-making is more concerned with reaching agreement among members on internal reforms than with responding to external pressures. Not only does the difficulty of the decision-making process make it almost impossible for the eurozone to “get ahead of the market,” but I have been struck by the number of Europeans who have told me that responding to the market is not the objective. Rather the objective is ensuring structural reforms in the weaker European economies which will eventually allow for a more unified economic policy approach, and eventually perhaps mutualization of debt, which is widely seen as the ultimate solution, but is currently politically impossible.

My third lesson from the crisis is that the crisis itself is essential to reaching decisions. We often assume that reaching decisions is harder during times of stress, but at least in Europe, that stress forces the 27 leaders to understand that some movement is required. Jacob Kirkegaard and Fred Bergsten have written about this in the current crisis, but speaking as someone who has watched the EU for many years, I can vouch that crisis is often a necessary ingredient to moving Europe forward across all sorts of issue areas. We should also remember, when assessing statements from European leaders that seem extreme – such as the German vice chancellor’s comment that a Greek departure from the eurozone has “lost its horror”— that while it may reflect that person’s views, it is also a useful threat just before the “troika” arrives to tell Greece it must proceed with difficult reforms. Intra-European negotiations are not for the faint-hearted.

My final lesson is that decision-making in the EU must reconcile very different national domestic situations. Every country brings its own experiences to the negotiating table. While Greece, Spain, Portugal, and Italy are genuinely hurting in terms of unemployment and general economic stress, Germany and others in northern Europe remain very comfortable. Yet only a few years ago, Germany had one of the weakest economies in Europe — a situation that the German populace blamed on the generous economic transfers given to the new, eastern part of their country after unification. They also experienced difficult economic reforms, including raising the pension age and making it easier to fire workers. It is no wonder that the average German is not willing to transfer financial resources to Greece before that country has undergone reforms similar to those Germans experienced themselves. Angela Merkel faces elections in fall 2013, but I for one am not worried about her chances: her approval rating recently reached 66 percent[1] and only in the last few days has there been much public criticism of her handling the economic crisis.

What does all this mean for the future of Europe and the eurozone, and most importantly for this Committee, for the United States and its partnership with Europe? First, we will be dealing with this crisis for some time to come, probably two years at least and perhaps longer. What is likely to emerge very gradually is a much more integrated eurozone, providing Europe with a core group of countries that have undergone serious structural reform. But growth will be slow in returning.

[1] ARD poll, July 6, 2012

At the end of the crisis, the core group will not be much smaller than the current eurozone; I see Greece as the only member seriously at risk of leaving. In that situation, the other members will make sure that Greece is not pushed but rather that Greek politicians decide to leave the eurozone. Given the popularity of the euro in Greece, this would be political suicide. Thus, the EU will effectively become three clubs: those in the eurozone; those pledged to join at some point in the future, that is, the "Euro aspirants"; and those who have opted out of joining the euro: Britain, Denmark, and Sweden. Most of the Euro aspirants, largely the new central European members, will stay closely engaged, seeking to influence the rules of the club they seek to join. But Britain and Denmark may drift farther from the EU, especially Britain, which is also not in the Schengen visa regime. That potential for drift should be taken into account as we look at the future of US-UK relations.

Some observers have warned of a rise in nationalism as a consequence of the financial crisis. It is true that any prolonged economic malaise is likely to lead some in societies to become more alienated. Europe is also going through a significant change in its ethnic makeup which is adding additional strains to its social fabric. However, in Portugal, Spain, Slovakia, and eventually in Greece, the voters opted primarily for mainstream parties committed to austerity. Even in France, the vote for M. Hollande seems to have been less against austerity than against Nicholas Sarkozy. The Front National received its highest tally ever in the first round this year, but they did not make it into the second round as they did in 2002, and they have far fewer seats in the Assemblée Nationale than they did in the 1980s. In the Netherlands, Geert Wilders caused a government crisis by withdrawing the support of his Freedom Party, but he also made it very unlikely that he will ever be included in a governing coalition again, even informally. Currently the left-center Socialist Party is leading in the polls with the election on September 12.

The outlook for right wing nationalist parties is mixed; indeed, we may see the rise of more leftwing extremism if austerity policies continue. One big uncertainty is Greece, which has a long tradition of anarchism and where Golden Dawn did better than ever in the most recent elections. But we should remember that in parliamentary systems, with the government and their parliamentary party unified, there is little role for parties that are not part of the government. Finally, the social safety net in most European countries gives the unemployed a relatively secure existence. Thus, my more serious concern is not with right-wing extremism, but with new immigrants, especially from the Muslim world, who are faced with few available jobs and difficulties integrating into society, and who fall prey to radicalism.

More serious than the prospect of European extremism is the potential for weak European economies, especially in the south and east, to become investment targets for companies and countries that may weaken adherence to good business practices and undermine economic policy. This is particularly true in the energy sector, where the need to privatize state energy firms may lead to purchases by Gazprom and other Russian firms just when Europe is making strides in reducing its energy dependence. We have also seen the Chinese make a significant investment in the Greek port of Pireaus, and it is reported that they are looking for other opportunities as Greece undertakes more privatization. And most recently, the Cypriot government, while in the EU presidency, is using the offer of a Russian loan to try to secure better terms for an EU bailout of its faltering economy.

What are the consequences of the eurozone crisis for the United States and its relationship with Europe? First, there is little we can do to affect the course or speed of European decision-making. Calls for Europe to lessen the rigors of austerity or to make speedier decisions will be largely ignored as the Europeans negotiate among themselves. Instead, we should focus on the new processes and institutions in Europe and how they might affect US firms and US regulations. There has already been some cooperation between Congress and the European Parliament on financial services regulation, and this should be strengthened as Europe now examines the possibility of a banking union, and possibly other measures such as a financial transactions tax. We also need to continue the close consultation already developed between European leaders and the US officials about what is happening in the crisis — especially concerning large cross-border banks — and potential contingency plans.

Second, we should avoid making the European financial situation seem more dire than it actually is. This only stimulates the markets into erratic behavior, but does not push European leaders toward finding a resolution. Instead, I believe the US and European Union face a significant opportunity in the form of a bilateral trade and investment initiative, which could stimulate growth and create jobs on both sides of the Atlantic. It seems counterintuitive to launch such talks with the eurozone in the midst of crisis, but the removal of tariff barriers, investment protections, and regulatory obstacles should add to the GDP of both regions at a time when that is much needed.

Third, we should continue to work with the Europeans to push forward the agenda of the G20. Many of the emerging economic powers regard this crisis as a European or North Atlantic phenomenon. Yet, taking the lessons of our 2008 crisis and the eurozone crisis and applying them in a global framework — as outlined in the declaration of the Los Cabos 2012 summit — is an important task. There are many topics addressed, but just to mention that they include labor reforms, country surveillance, enhancing transparency of credit ratings agencies, and tracking financial sector reforms makes clear that the US and Europe should work together to ensure that they are addressed equally among the G20 membership.

The eurozone crisis affects Europe, not only as an economic partner, but also as a foreign policy partner of the United States. There is no doubt that the policymaking bandwidth among European governments has been overwhelmed by the crisis. When European leaders meet — as they do very frequently — most of the agenda is focused on economic issues. Yet, the crisis was already well underway when European leaders pushed for the NATO operation in Libya and dedicated significant personnel and armaments to the cause. And Europe has continued to be an effective foreign policy partner on certain key policies. On Iran, the EU Vice President/High Representative Catherine Ashton continues to lead the efforts of the EU 3 plus US, Russia, and China in negotiating with Tehran. The EU has recently imposed sanctions on Iranian energy exports, despite the fact that Iran has been a supplier to several EU countries. The EU had to make compensatory arrangements for Greece, which had previously received one-third of its oil from Iran. These are sanctions that have a real cost for European countries. The EU stopped SWIFT, the Belgian financial transactions clearing house, from dealing with Iranian banks, a move that may have long-term consequences for that institution. The EU has also imposed sanctions on the Assad regime in Syria and with the US has argued for more sanctions at the UN. The EU naval mission ATALANTA continues to patrol against pirates off the horn of Africa, while a small, new mission is aimed at training local coast guards to undertake anti-pirate patrols. The EU and several of its member states have also reached out to the countries undergoing transitions in the Arab world. A new trade agreement has been launched with Morocco, but it remains to be seen if the EU will lessen barriers sufficiently for Tunisia, Libya, and Egypt.

But if the crisis has not taken much of a toll on these foreign policy initiatives, it has had an impact on the future of enlargement, which is the most successful European foreign policy initiative of the last twenty years. The crisis has lessened European appetites for bringing in new members and made the EU less attractive to potential members. Croatia will join next year as the 28th, but it is unclear when the next country might be ready to accede. Because the Balkan states are generally small and there is a feeling of obligation after the conflict of the 1990s, the Balkans are likely to be approved when ready. But the crisis has reduced the EU's attraction among some Balkan capitals even while adding more legislative and regulatory requirements for those seeking to join. The crisis has also diminished the possibility that any of the Eastern Partnership countries might be given a membership perspective if they wanted it. Finally, I think the crisis has significantly lessened any chance the Turkey will eventually join the EU, both because of EU concerns about the cost of such an accession and Turkish views of Europe in the wake of the eurozone crisis.

Even more important for the United States, the financial crisis has precipitated a crisis in European defense capabilities. For the past 18 months, we have heard a steady drumbeat of budget cuts forcing the abandonment of real capabilities among European militaries. These include the loss of British capability to launch fixed wing aircraft off carriers until at least 2018 and the disbanding of the last two Dutch tank battalions. Despite NATO's efforts to launch a "Smart Defense" initiative at the Chicago summit, it seems likely that our European allies will have limited capabilities available for deployment outside the immediate region for the next few years. The ending of the ISAF mission in Afghanistan will free up some capabilities, but there will be much reluctance in Europe to undertake global deployments. The impact of a long-term decline in European defense capabilities as a result of the eurozone crisis should be a priority topic among US and European leaders.

Despite the difficulties of the eurozone crisis, Europe remains a key foreign policy partner of the United States, as is demonstrated by Iran, Syria, and Afghanistan, among US foreign policy priorities. Even with the crisis, Europe remains the largest economy in the world, and the United States' leading partner in trade and investment. The eurozone crisis will change the transatlantic relationship, and in ways that we do not yet know or understand. But we should not let the crisis define the relationship. With wealth and power shifting away from the North Atlantic, this crisis can either divide the US and Europe, leaving us both with reduced influence in the world, or it can be an opportunity for reforming and strengthening our economies so that they remain globally competitive.

Madam Chairwoman, Dr. Barrasso, members of the Subcommittee, thank you for the opportunity to share my views. I look forward to your questions.