

## Is financial failure an option in the EU?

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The euro area confronts a fundamental crisis. The European Council of Ministers had to promise hundreds of billions of euros to its financially imperiled member countries, even though the European economy as a whole is not really in crisis. On the contrary, most surveys and hard economic indicators point to a strong upswing, with the one country that is in really serious trouble, Greece, representing only 3% of the area's GDP.

Nevertheless, the crisis poses an existential challenge to the European Union – and has required such huge sums – because it directly implicates the key underlying principle of European governance: the nature of the state. The case of Greece has raised the simple but profound question: can a member state of the EU be allowed to fail?

One view is that the state is sacrosanct: the EU has to intervene and help any errant member to get back on its feet. But this view assumes that all member states adhere to the Union's underlying economic values of fiscal prudence and market reform. Problems could arise only because of unanticipated shocks, temporary local political difficulties, and – the favorite culprit – irrational markets.

Applied to Greece, this view implies that the country's fiscal crisis resulted from an overreaction by world financial markets to local political difficulties (excessive spending by the Greek government before last year's elections). Moreover, it implies that the crisis is fully under European control, and that the European authorities have elaborated a comprehensive plan that will resolve all of Greece's fiscal and structural problems. Hence, the official – or more accurately, the 'Southern' – refrain: "The IMF/EU plan will succeed. Failure is not an option."

The alternative view is more pragmatic and rules-based. This 'Northern' view starts from the premise that member states remain sovereign units, and that it is possible that a member country does not implement a necessary economic-adjustment program. This view is embodied in the "no bailout" clause in the eurozone's founding document, which stipulates that each country is responsible for its own public debt. Failure then becomes an option if the country concerned violates the single currency's basic rules.

Financial markets do not participate directly in this debate, but they do have a large "skin in this game". Any holder of Greek debt, especially long-term debt, must calculate the likelihood that Greece's political system will prove strong enough to push through the reforms needed to enable the country to service its debt fully (and on time).

The collective judgment of financial markets on any government's economic and fiscal policy is expressed in the risk premium that the government must pay on its external debt. Doubts in financial markets lead to

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higher risk premia, which make it even more difficult to finance a government that is already facing financial problems. Financial markets are often wrong in their judgments, but they are a fact of life that cannot just be wished away.

One might object that the distinction between Southern and Northern views is academic nowadays, because failure really isn't an option, given that it would trigger a disastrous reaction in global financial markets. But the European Council also created a Task Force under President Hermann Van Rompuy to elaborate concrete proposals for reforming the monetary union which has already met at the level of Finance Ministers but without going much into the substance of the issues.

The key choice for this group is simple: should they direct their efforts solely at preventing failure (including open-ended fiscal support), or should they also prepare for the failure of a member state in order to mitigate the consequences if that should happen?

The first choice is bound to imply elaborate measures designed to deliver 'more of the same' – a strengthening of the Stability and Growth Pact, for example, with more provisions for economic policy surveillance and cooperation. So far at least, it seems that most member states (and the EU institutions) are only considering this approach. But this approach has no answer to the fundamental question: What if the framework does not work? So long as EU leaders cannot answer that question, financial markets will continue to harbour doubts about the euro's long-term stability.

The eurozone cannot stabilise in political and economic terms without a solid framework for crisis resolution and an ability to deal with sovereign default by a member state. The view that member states cannot be allowed to fail logically implies that a political or at least a fiscal union must underpin the euro.

This is the choice that European leaders must now confront: a radical step forward towards political or fiscal integration, or a clear framework to deal with the consequences of a member country's failure to abide by the fundamental rules of the monetary union. The latter does not require more integration, just the courage to admit failure at some point. No amount of money will allow European leaders to fudge this issue.