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**The EU Response to the Eurozone Crisis:  
Democratic Contestation and the New Fault  
Lines in European Integration**

Andrew Glencross

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## **The EU Response to the Eurozone Crisis: Democratic Contestation and the New Fault Lines in European Integration**

Andrew Glencross\*

### **Abstract**

*This paper analyses the EU's response to the Eurozone sovereign debt crisis. It examines the background to the crisis and how the threat to the single currency taxed the decision-making capacity of the EU, while also exposing long-standing fears about an absence of democratic legitimacy. In particular, the paper reflects on the democratic credentials of the EU response, examining the important role that continues to be played by democratic politics at the national level. This role will continue to be important since this is the level at which enforcement of debt brakes will occur. In addition, the analysis highlights the political fault lines that became apparent, notably the North/South split and the separation between countries inside and outside the Eurozone. Consequently, the paper concludes that these fault lines will characterize the future of integration, thereby complicating the search for a consensus on how to complete the banking union or pursue a free trade deal with the US.*

**Key words: Eurozone crisis, legitimacy, Fiscal compact, debt brakes**

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## **The EU Response to the Eurozone Crisis: Democratic Contestation and the New Fault Lines in European Integration**

Andrew Glencross

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### **1. Introduction**

The Eurozone crisis, a ramification of the 2008 financial crisis, called into question the viability of the euro. By 2013, the threat of a return to national currencies had receded as a result of unprecedented measures taken to shore up monetary union. Less obviously, the response to the crisis is having wide-ranging economic and political repercussions across the European Union (EU). Eurozone policy makers had to confront serious dilemmas about how to provide financial support to governments no longer able to fund their deficits and facing the possibility of leaving the euro. These choices have a fundamental impact on the direction integration is taking and expose certain fault lines in integration that were hitherto less visible.

The 2008 financial crisis sparked not only a banking crisis but also a sovereign debt crisis as governments in several Eurozone countries struggled to find the funds to rescue their insolvent banks. This problem highlighted the fact that monetary union was not accompanied by a banking union, leaving national governments responsible for regulating and rescuing banks from bad debts. The size of the latter was so huge that governments in Greece, Ireland, Portugal, and Cyprus could not afford to borrow such sums on the financial markets. Disorderly defaulting or a return to national currencies, bringing with them a new round of bank losses and uncontrollable contagion effects, made bailouts the less costly option. However, devising the terms of the bailouts taxed the decision-making capacity of the EU and exposed long-standing fears about an absence of democratic legitimacy.

This article thus analyses both the background to the Eurozone and the convoluted EU response. It does so in order to shed light on the nature of the conflicts over the democratic legitimacy of the bailouts and their conditions. Particular attention is then given to political fault lines that

became apparent in the Eurozone. Most notable is that between northern countries asked to provide bailout funds and southern ones in need of them. This division reflects not just different political attitudes but also different socio-economic models. In addition, the response to the crisis has increased national political contestation about the EU, adding another source of division as elites seek to reassure national opinion that they, rather than the EU, control key policy levers. The residual importance of this national level of democratic contestation is illustrated by examining the functioning of the debt brakes put in place via the so-called Fiscal Compact.

Reflecting on what the sovereign debt crisis means for the future of integration, the article concludes by showing how both the crisis and the EU's response illustrate fundamental characteristics of contemporary European integration. In the face of an unexpected emergency, national politicians took the lead and pressed ahead with more integration. The long-term results though depend on national acceptance of not just the bailout provisions but also enforcement of debt brakes (national legal limits on budget deficits) mandated by the new EU treaty. This means democratic politics at the national level will continue to have a fundamental influence on EU affairs, whilst the North/South split will co-exist alongside a more marked separation between countries inside and outside the Eurozone. In this context of increased political turbulence within the EU, there is likely to be only a limited window of opportunity for successful negotiation of a free-trade deal with the US.

## **2. The Background to the Eurozone Crisis**

Politically, the driving force behind economic and monetary union (EMU) in Europe was the desire to cement ever closer integration after the end of the Cold War, by tying a re-united Germany into unprecedented institutional cooperation in Europe.<sup>1</sup> In economic terms, the creation of the euro was sold on the basis of the benefits this would bring for trade and investment – eliminating the costs of currency exchange and making price competition easier, which is anti-inflationary. However, EMU did not just involve making business easier for firms. The EMU mechanism rested on rules for fiscal stability – the Stability and Growth Pact – that would prevent governments from borrowing too much on the back of a strong currency. In order

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<sup>1</sup> David Marsh, *The Euro: The Politics of the New Global Currency* (New Haven: Yale University Press. 2009).

to meet these conditions, Ireland, Portugal, and Spain re-organized their public finances to lower total public debt below the 60% of GDP allowed by the Maastricht Treaty. Italy and Greece never achieved this target but were nonetheless admitted into the euro.<sup>2</sup>

Nevertheless, the prelude to the introduction of the euro saw an improvement in the fiscal positions of states that had traditionally struggled to rein in public debt. Italy, most notably, enjoyed a virtuous circle as the interest rates of prospective Eurozone countries converged on the lower German one – the economic core of EMU. This made it easier to balance budgets as the cost of servicing national debt decreased substantially. The period after the launch of the euro was also beneficial for states accustomed to paying a higher rate of interest on debt. Although individual governments were responsible for their own debt, financial markets were not overly worried about differences in public finances because the SGP set national limits on Eurozone debt. As a result, countries such as Greece and Italy continued to pay low interest on their debt, which markets regarded (seemingly erroneously) as a safe investment like that of Germany.<sup>3</sup>

However, there is a less visible feature of EMU in that having a shared currency ultimately puts pressure on participating governments to adopt more liberalizing policies for improving national competitiveness.<sup>4</sup> A single currency does more than just complete a single market. In addition, monetary integration adds impetus to de-regulate in areas beyond formal EU competence or where EU legislation is hard to adopt e.g. taxes on labor, services, employment contracts. This pressure comes from being locked into a common currency, making currency devaluation no longer an option. In this context, a government in a country whose goods or services become less competitive compared with those of another country cannot suddenly level the playing field by lowering the value of its currency. Under a shared currency, competitiveness instead has to come by changing costs such as lowering salaries or improving productivity through investment and innovation. Although a longer-term form of adjustment, economists consider productivity gains a better means of achieving lasting, stable growth as recurrent devaluations scare off investment and discourage entrepreneurship. Politically, however, lowering production costs is very challenging as it translates into diluting union power, lowering wages, and reducing employment rights.

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<sup>2</sup> Philip R. Lane, “The European Sovereign Debt Crisis,” *The Journal of Economic Perspectives*, vol. 26 (2012), pp. 49–67.

<sup>3</sup> *Ibid.*

<sup>4</sup> Peter A. Hall, “The Economics and Politics of the Euro Crisis,” *German Politics*, vol. 21 (2012), pp. 355–371.

Trade in the Eurozone increased by 10-15% within half a decade<sup>5</sup> but overall economic growth was actually very similar amongst Eurozone and non-euro EU countries in the decade before the financial crisis.<sup>6</sup> Moreover, whilst the ECB managed to accomplish its statutory goal of achieving an annual inflation of 2% or less during this decade, non Eurozone countries such as Sweden and the United Kingdom also achieved this rate<sup>7</sup>. Yet the problem with EMU is less that it disappointed expectations about stimulating growth than that it failed to prompt productivity gains across the Eurozone. Imbalances in competitiveness and productivity made the Eurozone weak in the face of an unexpected crisis, which came in the form of a worldwide banking crisis that began in the United States.

The collapse of several banking institutions in the US in 2008 led to a wave of private debt defaulting that affected European-based financial institutions also exposed to these defaults. With no Eurozone-wide mechanism for rescuing banks threatened by insolvency it was up to national governments to step in and lend to banks, even if this meant additional national debt. The sheer amount of debt taken on by governments to bail out banks spooked investors. In Ireland rescuing the banks cost 40% of GDP – a necessary evil as a banking collapse would have been even more severe, wiping out customer savings, freezing the flow of credit in the economy, and even raising the risk of civil strife.<sup>8</sup>

When countries intervened to protect their banks from insolvency they did so in a context in which the banking sector had grown enormously since the creation of the euro. Bank lending had increased as EMU facilitated lending within the Eurozone whilst lower interest rates allowed individuals to borrow more for consumption. These developments illustrate the risk of having a shared currency without a banking union to coordinate the regulation of banks (e.g. how they make loans) and their rescue in crisis moments (e.g. guaranteeing deposits, injecting capital to prevent insolvency).

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<sup>5</sup> Tal Sadeh, “The End of the Euro Mark I: A Sceptical View of European Monetary Union,” in Hubert Zimmermann and Andreas Dür, eds., *Key Controversies in European Integration* (Basingstoke: Palgrave Macmillan), pp. 121–29.

<sup>6</sup> Ibid., p. 237–8.

<sup>7</sup> Jay C. Shambaugh, “The Euro’s Three Crises,” *Brookings Papers on Economic Activity*, Spring 2012 ([http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2012\\_spring\\_bpea\\_papers/2012\\_spring\\_BPEA\\_shambaugh.pdf](http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_shambaugh.pdf)).

Investors' fears about national solvency led to a freeze in the credit available to certain governments desperate to cover bank losses and revenue shortfalls stemming from the slowdown in the global economy. Consequently, the predicament facing Eurozone countries was either to borrow money from other Eurozone countries or else to go bust by failing to make payments on national debt or not paying salaries, pensions and other liabilities. These concerns about the solvency of Eurozone countries first surfaced in Greece in late 2009. After the general election of October 2009, the new Greek government dramatically announced that its annual budget deficit would be nearly 13% of GDP. This represented double the previous government's estimate and four times the amount allowed by the Stability and Growth Pact. Immediately after, Greece's total debt was re-evaluated at around 130% of GDP, more than double the statutory 60% limit inscribed in the EU treaties. This revelation left financial markets reeling and meant that to attract buyers for 10-year government bonds Greece had to pay an interest rate 4% higher than for equivalent German debt.

Faced with this shock, financial institutions' fears about the state of government finances spread. Soon after, Ireland and Portugal also started having to pay a much higher rate of interest when selling government bonds. Unlike Greece, Ireland pre-2008 was cutting its overall public debt to GDP ratio, as was Spain. Yet these countries were badly hit by the global recession, as well as the collapse of house prices following an unsustainable construction and financing bubble. Higher interest rates on debt thus came at the worst possible time for countries with precarious public finances during a severe global recession. In the space of a year, three Eurozone countries, Greece, Ireland, and Portugal, found themselves in this position within the space of a year, risking a sovereign default or an exit from the Eurozone if other members had not provided them with emergency loans.

### **3. The Convoluting EU Response**

A Eurozone bailout of countries in financial difficulty was not supposed to happen. Article 125 of The Lisbon Treaty states that heavily indebted countries will not have their debts paid by others. More importantly, the Stability and Growth Pact was designed to prevent governments from getting into this situation. In the first decade of the euro, however, it was in fact easier to accrue such debts given the lower interest rates available to countries such as Greece and Italy.

Ireland and Spain, which later had similar debt issues, nevertheless kept within the SGP rules. Politically, in the midst of a severe economic shock, it was never going to be easy to find a solution that required governments to take on huge financial commitments to keep the Eurozone intact. Hence the major political division, impeding a swift response, was that between governments in a healthy fiscal state (low annual debt and easily sustainable total debt) and those worried about their own finances.

As the cost of issuing new debt in Greece, Ireland, and Portugal became prohibitively expensive, or insufficient to cover their spending commitments, the policy choice was a binary one: leave the euro or negotiate a bailout. A country could in principle, although there is no official legal mechanism for this, leave the single currency. However, the return to a weak, national currency would have created a new round of bad debt as Eurozone bank assets were converted to a devalued currency. A further consequence is the inevitable contagion effect, whereby financial markets would speculate on who might be next out of the single currency, potentially triggering instability and runs on banking systems across the Eurozone. Thus the cost of Greek withdrawal from the euro was estimated at a staggering 1 trillion euros.<sup>9</sup> Consequently, there were good reasons why Eurozone governments decided to proceed with bailout packages for countries that could no longer borrow on the international financial markets.

Determining the conditions on which to provide a bailout, first for Greece, and then for Ireland and Portugal, and in 2013 Cyprus too, posed a question of leadership and legitimacy. The President of the Commission as well as the President of the European Council entered the fray at various points. However, the source of these emergency loans was the member states, complemented by monies from the IMF. Since national governments and their taxpayers would have to guarantee the funds it was national leaders that played the decisive role in devising the terms of the bailouts. In particular, it was German chancellor Angela Merkel, who played the most prominent role as the leader of the Eurozone's major economic power and the greatest financial contributor to these schemes.

Merkel's proposed solution involved giving emergency funding to countries frozen out of the financial markets in return for dramatic domestic economic and fiscal reforms. For instance, the agreement with Ireland spelled out which taxes should be raised and where public spending

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<sup>9</sup> Andrew Moravcsik, "Europe After the Crisis: How to Sustain a Common Currency," *Foreign Affairs*, May/June 2012.

should be cut, notably by reducing public service employment. For European integration, this form of top-down economic management constitutes an historic turning point as never before has the EU been so implicated in deciding national tax and spending policies.

As the EU treaties did not specify any mechanism for bailing out a Eurozone country, any funding arrangement was necessarily temporary unless the treaties were formally changed. With the risk that uncertainty over public finances would spread to countries such as Italy and Spain – as it in fact did by late 2011 – Merkel pressed for the creation of a permanent bailout fund. The plan was to reassure markets about the long-term commitment to the single currency by creating a €500 billion fund, known as the European Stability Mechanism (ESM), to provide loans to governments experiencing financial trouble. Establishing the ESM required a new treaty, signed at a European Council summit in February 2012, but Eurozone creditors, led by Germany, demanded a counterpart. This came in the form of a Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (also known as the Fiscal Compact), designed to create more robust rules for ensuring national fiscal discipline.

Negotiations over the Fiscal Compact were swift but not without complication, with the impetus again being provided by German chancellor Angela Merkel. Her overriding concern was that a new treaty would reassure German public opinion that the EU bailout mechanism was being accompanied by serious measures to prevent future crises requiring contributions by German taxpayers. Indeed, the most important of these measures was inspired by recent German legislation designed to make it constitutionally impossible to run up government debt in the long-term. At the heart of the “Fiscal Compact” is the creation of binding national commitments to run balanced budgets. The latter is modeled on the *Schuldenbremse* [debt brake] Germany introduced in 2009.

Applied to the EU, the Fiscal Compact’s debt brake compels signatories to the treaty – the United Kingdom and the Czech Republic have not signed it – to pass national laws limiting budget deficits to 0.5% of GDP. This figure is calculated in terms of the business cycle thereby permitting temporary spending rises during recessions. All countries using the euro have had to ratify the treaty, which entered into force on 1 January 2013. Eurozone countries have a major incentive to actually introduce a national debt brake immediately into law. This is because from March 2013 loans made by the ESM are conditional on a member state adopting the national debt brakes mandated by the Fiscal Compact.

Although this treaty does not give the EU competence to control how countries actually enforce their national debt brakes, the Court of Justice is empowered to verify whether member states actually pass this legislation within the specified one-year timeframe. Financial penalties of up to 0.1% of GDP can be imposed on governments that fail to adopt this legislation. An additional constraint imposed on signatories is the obligation, for countries with total debt of more than 60% of GDP, to reduce this by one-twentieth per year until below the 60% threshold. This commitment only becomes binding 3 years after an annual budget deficit has returned to below 3% of GDP. Taken together, these commitments are supposed to remove the likelihood of governments running up new debts and to reassure financial markets, eventually lowering interest rates on debt.

However, the new treaty does not significantly enhance the EU's ability to control national governments' fiscal decisions. The Fiscal Compact relies instead on getting member states to make the provisions of the SGP binding under national law. There was a suggestion of empowering the European Commission's monitoring ability by giving it the right to veto national budgets that do not conform to EU debt rules. Again this was an idea originating in Germany and supported by countries such as Finland and Austria that managed to keep control of government finances even amidst a global recession. A majority of other member states successfully opposed this move towards enhanced supranational budgetary control. Consequently, there are fears that the supranational mechanism for enforcing fiscal rigor will again be too weak, meaning the system will be reliant on national enforcement via debt brake legislation. In any case, the operation of debt brakes will take time as member states are expected to use transitional arrangements to bring deficits down gently whilst the commitment to pay back 1/20 of total debt over 60% of GDP can only be enforced after a 3 year period i.e. not before 2016.<sup>10</sup>

In order to deal with more immediate matters, therefore, the Fiscal Compact has been accompanied by gradual moves towards a banking union to resolve problems that were the root cause of many Eurozone countries' bad debts. Starting in 2009, the European Commission proceeded with "stress tests" on EU banks, to identify whether they have sufficient assets to cope with bad debts. Since 2010, this is now the responsibility of the European Banking Authority.

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<sup>10</sup> Sébastien Dullien, "Reinventing Europe: Explaining the Fiscal Compact," 2012 ([http://ecfr.eu/content/entry/commentary\\_reinventing\\_europe\\_explaining\\_the\\_fiscal\\_compact](http://ecfr.eu/content/entry/commentary_reinventing_europe_explaining_the_fiscal_compact)).

This independent agency increased capital requirements for banks in 2011, a measure designed to restore confidence in inter-bank lending. In addition, in December 2012 the EU agreed to give the ECB the power to supervise (starting in 2014) the EU's banks to prevent risky lending practices or unsustainable business models. This is a major step intended to break the link between bank losses and sovereign liquidity problems of the kind that necessitated bailouts in Ireland and Portugal.

In November 2012, the European Commission approved a €37 billion euro package for four heavily indebted Spanish banks, in return for major restructuring involving significant branch closures and job losses. This was another milestone as it moves the Eurozone closer to a system of mutual bank support, although other aspects of a banking union, notably a commonly funded bank deposit guarantee, remain under discussion only. Ultimately, the intention is to counteract the fact that, as the economist Charles Goodhart put it, '[EU] banks are international in life, but national in their death'.<sup>11</sup> However, this move involves mutualizing financial risks across member states, which is highly controversial, as indeed are most aspects of the EU response to the Eurozone crisis – notably the issue of how democratic the decision-making process has been.

#### **4. Democratic Decision-Making?**

The controversy surrounding how the EU dealt with the aftermath of the financial crisis involves more than just wrangling over money. When the repercussions of the 2008 financial crisis struck the Eurozone the problem was not just the EU's ability to take decisions but also the ability to get democratic approval for tough choices. The quality of democratic governance in the EU has long been a vexing topic, with accusations that the EU has a fundamental democratic deficit countered by arguments seeking to absolve EU governance of such blame. Yet the sovereign debt crisis posed this question in much starker terms than ever before. This is because

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<sup>11</sup> Charles Goodhart, "Procyclicality and Financial Regulation," *Banco de España Revista de Estabilidad Financiera*, vol 16 (2009), pp. 11-20 (quotation p. 16). (<http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/09/May/Fic/ief0116.pdf>).

governments in some countries are committing public funds to make up shortfalls in the budgets of other countries in return for major socio-economic reforms beyond anything conducted under ordinary EU legislation. Both moves met with deep domestic opposition: citizens from creditor countries were skeptical about the wisdom of providing bailouts whilst mass protests broke out against the socio-economic reforms being imposed in recipient countries such as Greece and Spain.

In this context, the interplay of national and EU politics has played a fundamental role as politicians try to balance the constraints of both when attempting to shore up the Eurozone. The case of Germany illustrates well this dilemma. Chancellor Angela Merkel knew that her citizens were very wary about providing emergency loans to Greece. German public opinion blamed government economic mismanagement for Greece's debt problems as exemplified by the fact that full pension rights were based on 35 years' contributions, ten less than in Germany. Merkel thus wanted to design a bailout deal that would convince her national voters that the EU was serious about reforming how countries run their economies. In addition, she was concerned that the German Constitutional Court would rule financial support for Greece and others illegal unless a new treaty overturned the Lisbon Treaty's no-bailout clause.<sup>12</sup>

Consequently, German domestic preferences were central to how Merkel approached solving the sovereign debt crisis. The insistence on getting a deal that satisfied these preferences engendered some hostility from other EU member states concerned that their voices were not being heard. Hence this attitude on the part of the German leader raised the specter of a German-run Europe. At the popular level, this anxiety about German dominance meant that street protests in Greece or Portugal against reforms introduced to satisfy EU creditors were invariably accompanied by anti-Merkel slogans and allusions to Nazi-era Germany. These demonstrations were also a manifestation of domestic opposition to EU-imposed socio-economic reforms, notably tax increases, reduced pension or unemployment benefits and public sector layoffs. Such measures, an essential part of the terms of the Eurozone bailouts, were portrayed as the imposition of "austerity" by external creditors without the approval of national voters. When, in November 2011, the then Greek prime minister George Papandreou proposed a national referendum on the terms of the EU bailout, European leaders successfully applied diplomatic pressure for him to

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<sup>12</sup> William E. Paterson. "The Reluctant Hegemon? Germany Moves Centre Stage in the European Union," *Journal of Common Market Studies*, vol. 49 (2011), pp. 57–75.

abandon this plan, leading to his eventual resignation. EU leaders were afraid that voters would reject the deal, thereby unraveling their attempts to solve the crisis.

Another indication of the external constraints facing member states' ability to decide their own affairs came from Italy. With a very large public debt of over €2 trillion, Italy has long been preoccupied with interest rates on its debt as small variations can have large effects on how much it costs to service outstanding debt. In late 2011, financial markets rapidly lost confidence in the Italian government's ability to reform its public finances. This was not just the result of contagion as fears about government finances spread from Greece to other countries but also a damning verdict on the inability of Prime Minister Silvio Berlusconi to carry out numerous pledges to reform the Italian state.<sup>13</sup> With pressure to improve Italian public finances also coming from European leaders, namely Angela Merkel and Nicolas Sarkozy, as well as the ECB, Berlusconi lost his parliamentary majority and resigned. In his place came, without a new election, a non-partisan government led by former EU commissioner Mario Monti. The aim of this move was to allow experts – a so-called technocratic government above partisan politics – to stabilize the country's finances and reassure financial markets until elections in 2013. External actors such as markets and powerful EU member states thus seriously constrain the policy choices available to voters in weaker EU countries.

The Italian example is also emblematic of the instability in governing across the EU since 2008. That is, governing parties have found it extremely difficult to win re-election as shown by electoral defeats for ruling parties in France, Finland, Greece, Ireland, Portugal, Slovakia, and Spain. In the latest setback Mario Monti, the leader of the technocratic Italian government, failed in his attempt to put together a winning electoral coalition committed to further fiscal discipline. In many of these cases, electoral unpopularity was directly linked to governments' implementation of socio-economic reforms and moves towards fiscal rigor. Moreover, in the Netherlands, the government of Mark Rutte fell in April 2012 when his coalition failed to get parliamentary support for budget cuts aimed at conforming with the Stability and Growth Pact. Yet a change in government does not affect a member state's legal obligations: ruling parties and coalitions still have to meet EU budget rules or, in the case of recipients of bailouts, meet the terms of these agreements. Consequently, popular resentment against austerity has not led to a

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<sup>13</sup> Erik Jones, "Italy's Sovereign Debt Crisis," *Survival: Global Politics and Strategy*, vol. 54 (2012), pp. 83–110.

change in policy direction, thereby revealing just how constrained economic sovereignty has become for Eurozone countries.

## **5. The New Fault Lines in European Integration**

The terms of the EU bailouts – money in exchange for fiscal discipline – clearly indicate that wealthier northern European countries expect their southern neighbors to become more like them. This is by no means impossible. Ireland’s ability to start borrowing on the financial markets already in July 2012, followed by Portugal in early 2013, indicates rapid fiscal improvement is possible. Nevertheless, it is important to recognize how far divisions in the Eurozone over resolving the sovereign debt crisis represent socio-economic as much as political differences across member states.

The core areas of prosperity, centered on Germany and its immediate neighbors, are typified by intensive capital investment, highly skilled labor, and export-led growth. This contrasts with the southern periphery, notably Greece and Portugal but also southern Italy, reliant on low-cost labor and dependent on demand-led growth (Hall 2012).<sup>14</sup> Joined together under a common currency, the less competitive countries of the Eurozone lost the ability to devalue their currency. This allowed firms from more competitive countries to gain market share and to invest more, allowing them to adapt better to changes in the global economy. Moreover, German firms benefited from lower unit labor costs (the ratio of pay to productivity) relative to the Eurozone because of high capital investment as well as weak domestic demand, more flexible working practices, and low government spending. The result was that companies in Germany became up to 25% more competitive than their counterparts in Italy, Spain, Greece, and Portugal.<sup>15</sup>

Unsurprisingly, therefore, it is the design of the single currency itself that is often identified as the ultimate cause of the fiscal problems besetting weaker Eurozone countries. However, EMU was always intended to be a covert mechanism for improving competitiveness via more liberalizing policies. Hence the North/South fault line that has emerged is not just one between creditor and debtor countries. A key part of this divide is national capacity to implement socio-economic reform and fiscal consolidation.

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<sup>14</sup> Hall, “Euro Crisis”.

<sup>15</sup> Moravcsik, “Europe After the Crisis”.

Some countries have been able to implement sweeping fiscal reforms of their own accord, without supranational pressure. This was the case of Sweden in the 1990s: owing to public sector layoffs and a significant reduction in welfare provision, the budget deficit went from 10% of GDP in 1993 to less than 2% in 1997.<sup>16</sup> Similarly, throughout the 2000s Germany pursued major welfare reforms and introduced a debt brake to control federal as well as regional spending. By contrast, the institutional capacity and political will to implement such costly reforms is still absent in many countries. Italy, despite having a nominally centre-right government and the competitive pressures of a shared currency, has remained wedded to “embedded illiberalism” in its welfare and labor market rules.<sup>17</sup> The same reluctance to reform can be seen from the political debates across member states relating to how to resolve the sovereign debt crisis. The 2012 French Presidential election, for instance, was won by a left of center politician with an anti-austerity platform. Greek politics also saw a fierce battle over whether to go along with the terms of the bailouts. The socialist party Syriza, which became the second biggest parliamentary party after the 2012 election, strongly opposed EU-imposed cuts in public spending although ultimately a coalition of parties supporting the bailout was able to form a government.

This trend of national contestation over meeting the terms of the bailouts as well as the Eurozone’s German-led emphasis on fiscal discipline point to another fault line within EU democratic governance. Within many EU member states there is a growing tension between political elites and ordinary voters, which in turn is destabilizing attitudes towards integration amongst national elites. This situation contrasts with the situation at the start of the European integration process, when questions about how it should be organized and what policies should be pursued were kept largely separate from national politics.

It is the spread of EU competences, reaching a new height with top-down socio-economic reforms linked to Eurozone bailouts, that has increased the salience of the integration dimension in national politics. This is the environment in which fringe parties thrive by mobilize eurosceptic opinion, as with the UK Independence Party, the True Finns in Finland, or the Danish People’s Party. The result is that mainstream political parties are forced to reconsider their stance on integration, often revealing internal divisions on a subject they, for good reason,

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<sup>16</sup> Karen M. Anderson, “The Politics of Retrenchment in a Social Democratic Welfare State: Reform of Swedish Pensions and Unemployment Insurance,” *Comparative Political Studies*, vol. 34 (2001), pp. 1063-1091.

<sup>17</sup> Jonathan Hopkin, “The Trouble with Economic Reform: Understanding the Debt Crisis in Spain and Italy,” working paper (2013), available at <http://personal.lse.ac.uk/hopkin/Hopkin%20Economic%20Reform%202013.pdf>

tried to avoid debating. Difficulties in maintaining party discipline over EU integration and increased media scrutiny operate as a domestic constraint on the kind of deals elites can make to solve EU policy problems.

The Eurozone crisis' tendency to exacerbate internal party divisions over EU integration is particularly acute in the United Kingdom. It was precisely to appease eurosceptic elements in his Conservative party that British prime minister David Cameron refused to sign the Fiscal Compact in 2011. This opposition left the United Kingdom very isolated as did its reluctance to establish greater supranational banking regulation for fear of hurting the financial interests of the City of London. Furthermore, in 2013 Prime Minister Cameron announced his intention, if re-elected in 2015, of re-negotiating the UK's relationship with the EU and then subjecting this deal to an "in or out" referendum on staying in the EU. Around this time, opinion polls suggested that 70% of Britons were "not very" or "not at all" attached to the EU.<sup>18</sup> Whether this trend of seeking alternative arrangements spreads – Sweden and the Czech Republic also objected to joining the new banking union – will determine whether the EU will experience more internal differentiation.

Furthermore, the Eurozone crisis reveals that the major threat posed by increased domestic contestation over EU integration is the de-legitimation of decisions associated with political actors from other countries. For instance, the German parliament or constitutional court is happy to have the final say on the legality of the EU bailout fund at the same time as the German government pressured the Greek prime minister not to hold a referendum on the terms of the EU bailout. Similarly, whilst the French government chafed at giving the EU Commission greater say over national budget as part of a strengthened Stability and Growth Pact, it enthusiastically supported the replacement of Silvio Berlusconi by a technocratic government, precisely for the sake of better implementing austerity measures.

Hitherto, the EU has accommodated the existence of more than a single democratic political community and thus the messy co-existence of multiple accountability claims made in the name of countries or peoples. In light of national tensions produced by the response to the Eurozone crisis, there is thus a very real threat of a retreat to a purely national definition of democratic

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<sup>18</sup> Peter Kellner, "Who Might Win a British Referendum on Europe?", [http://ecfr.eu/content/entry/commentary\\_who\\_might\\_win\\_a\\_british\\_referendum\\_on\\_europe](http://ecfr.eu/content/entry/commentary_who_might_win_a_british_referendum_on_europe)

legitimacy. That is, in some countries political elites are seeking to reassure their citizens over their (elusive) control of integration by rejecting the legitimacy of decisions not taken by their own people. In an EU of 27 – 28 when Croatia joins in July 2013 – this kind of move will lead to further policy blockages over the socio-economic reform the future of EMU depends on.

## **6. Conclusion: What the Crisis Means for the EU's Future**

Both the Eurozone crisis itself and the EU's response to it illustrate fundamental characteristics of contemporary European integration. Never before have complicated EU policy debates played such a central role in national politics, as shown by government instability in the face of meeting EU budget rules. Equally, the response to the crisis, notably the evolution of the ECB's role and the scrapping of the no-bailout policy, shows the EU's capacity for flexibility. As is the historical trend,<sup>19</sup> an unexpected situation revealed incompleteness in the stage of integration reached – the construction of monetary union without a banking union – and forced policy makers to respond.

National leaders were at the forefront of deciding the EU response to the sovereign debt crisis, relegating the Commission and the Parliament – but not the ECB – to secondary roles. This largely intergovernmental approach is understandable because it is national governments that have to secure parliamentary and constitutional approval for bailouts and austerity measures. Nevertheless, in a new departure for integration it was one country in particular that set the agenda. Germany, the economic powerhouse of the Eurozone and the biggest contributor to bailout packages, played a central role in determining that indebted countries would need to implement austerity. Many governments have seen their macro-economic policy options greatly constrained in order to meet the conditions for reforming the Eurozone instituted by German chancellor Angela Merkel. National electorates have thereby discovered just how far economic sovereignty is a cooperative affair, limiting the autonomy of national governments, chiefly the ability to accommodate their citizens' tax and spending preferences. In Italy, notably, a temporary technocratic government had to be formed to reassure financial markets by reducing public spending. Moreover, governments implementing fiscal reforms have been voted out of

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<sup>19</sup> Moravcsik, "Europe After the Crisis".

office across the EU even though their successors have to meet the same terms, whether in the form of the SGP or in separate bailout agreements.

Despite the instability in national politics provoked by the Eurozone crisis and the EU's remedies, the future of the euro is fundamentally dependent on national acceptance of fiscal reform. This comes principally in the form of debt brakes, introduced via the Fiscal Compact, which rely on national legal implementation. National acquiescence cannot be taken for granted, as demonstrated by trends both within countries providing bailouts and in those receiving them. In the former, there is skepticism about financial solidarity whilst in the latter there is popular resistance to this form of supranational economic intervention. In this context, divisions within the EU, namely the north/south split, have grown apparent as have splits within national politics as voters in Spain and Greece debate whether to accept the terms of the bailouts.

The sovereign debt crisis thus highlights not just problems of democratic legitimacy for introducing reform but also fault lines in economic and political solidarity. Mutual financial guarantees were necessary to preserve the single currency but national electorates in creditor countries did not welcome this move, a clear indicator of the domestic political obstacles to creating a fiscal union. Moreover, many citizens in countries requiring a bailout have objected to having to meet the conditions imposed at the demand of other EU member states. Another question mark over solidarity is posed by the reinforcement of the distinction between those outside of the single currency and those using the euro. On the one hand, the Eurozone area has strengthened its informal system of cooperation, the Eurogroup (euro-area finance ministers) to present a united Eurozone front on economic and financial policy. On the other hand, moves towards a banking union and more economic coordination for the EU triggered added wariness towards integration amongst British eurosceptic parties.

Overall, the sovereign debt crisis is perhaps the toughest challenge the EU has faced. In light of this, the choice to move towards a banking union is a clear signal that European political elites still support more integration to resolve the vulnerability of the single currency. The launch of negotiations for an EU-US Transatlantic Trade and Investment Partnership in March 2013 – overcoming entrenched skepticism from certain EU governments and lobbies – is another sign of this commitment. From a US perspective, therefore, this free-trade deal represents a unique opportunity to enable EU partners to realize the benefits of ever closer union by participating in the world's biggest bilateral trade deal. Although there are numerous thorny regulatory issues to

address, the negotiations are perhaps the best chance of kick-starting the EU economy and consolidating the nascent US recovery.

The window for achieving a deal might well be limited. For it is uncertain how much longer EU elites will be able to resolve internal crises by resorting to more integration. Such a move depends not just on what financial burden voters in creditor states will accept in exchange for keeping the euro intact. The commitment to more integration is also conditional on the acquiescence of voters in the countries that have been bailed out as well as in those where fundamental socio-economic reform is necessary to balance the budget. Likewise, national parliaments will have to ratify any EU-US trade deal negotiated by the European Commission. The euro-enthusiasm of parliamentarians is not a given and hence neither is national politicians' ability to persuade citizens to choose more integration.