CRISIS OBSERVATORY

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Abstract

Despite the latest 'Cyprus saga', there has been no fundamental change concerning the euro crisis: the ECB's decisiveness, the substantially reduced risk of a euro exit, and cautious attempts towards addressing the incomplete EMU construction has substantially reduced the danger of a systemic meltdown. However, the epicentre of the crisis has shifted to other equally worrying dimensions: the social and political. Policy-makers at EU and national level will have to overcome the prevailing 'lets-wait-and-see' mode and intensify their efforts to cushion the negative effects resulting from a years-long recession and unbearable high levels of unemployment. Contrary to last September, there will be no actor equivalent to the ECB able to act swiftly and decisively enough to avert a potential deterioration of the crisis in case things should politically get out of control in one or the other Member State or even between EU countries.

Key Words:

Crisis, European Union, EMU

Where do we stand and what to expect? – an analysis of the "state of the crisis"

With respect to the current 'state of the crisis' there is both good and bad news. Let us start with the good news: despite the rather clumsy mishandling and the still unpredictable longer-term effects of the latest 'Cyprus saga', there has been no fundamental change concerning the euro crisis. The decision of the European Central Bank (ECB) in September 2012 to provide a 'big bazooka' through its conditionality-based Outright Monetary Transactions (OMT) programme, the substantially reduced risk of a country leaving the euro zone, and cautious attempts towards addressing the incomplete EMU construction (including first moves towards a banking union) have increased confidence in the common currency and substantially reduced the danger of a systemic meltdown. Falling yields on sovereign bonds, rising capital inflows into Europe, a gradual increase in bank deposits in crisis-hit countries (with the exception of Cyprus), a shrinking of the ECB's balance sheet, an increase of exports and a reduction of current-account deficits in countries most hit by the crisis, an improvement in business and market confidence despite the Cyprus bailout, and Latvia´s application to join the euro in 2015 – a strong sign of confidence in the long-term future of the euro – all indicate that the situation has improved.

But now comes the bad news: the financial-economic crisis is by no means over and the epicentre of the crisis has shifted to other equally worrying dimensions of the crisis. Conditions in the banking sector remain troublesome: high private debt levels are causing increasing problems as many households cannot service their loans and the European financial system remains highly fragmented causing more and more refinancing problems especially to medium- and smaller-sized companies in the countries most hit by the crisis. Sovereign debt levels are still rising, mostly due to economic contraction; the potential long-term consequences of the Cyprus bail-out (including a 'haircut' on bank deposits and the introduction of temporary capital controls) are not foreseeable; Slovenia has come under pressure and might become the next (last?) programme country; the economic forecasts for almost all EU countries are gloomy at least until the end of 2013; and, last but certainly not least, (youth) unemployment has in many European countries reached unbearable, record-high double-digit levels and even the expected or rather hoped for (limited) economic recovery will not have immediate and substantial positive effects in the labour market.

Shift of attention to the socio-political dimension

While the danger of a systemic euro meltdown has decreased, attention has shifted to the social and political consequences of the crisis. Citizens are dissatisfied with political elites and are showing their dissatisfaction with the 'old establishment' and with 'Brussels'. The rise of Beppe Grillo and his Five Star Movement in Italy, of Golden Dawn and Syriza in Greece, of Marie Le Pen in France, of the True Fins in Finland, of the UK Independence Party, and the thousands of protesters on the streets of Bulgaria, Spain or Portugal signal the increasing discontent with the current state of affairs and even raise concerns about the state of democracy in Europe.

Many of these movements/parties employ anti-euro/EU rhetoric to support their cause, but none of them have been – at least until now – able to formulate a credible alternative to EU/euro integration, although some of them claim to have done so. A further worsening of the situation on the ground could give these political forces an additional boost not 'only' at national but also at European level, where there is a good chance that EU-critical or even EU-phobic forces will become more prominent in the European Parliament (EP) after the 2014 elections.

Citizens in the countries most affected by the crisis have either reached, or are close to reaching, the point where they are no longer ready, willing or able to bear its negative collateral effects. A long-lasting recession, higher taxes and cuts in welfare, the rise of (youth) unemployment, and a loss of hope have resulted in collective frustration, despair and anger, increasing the risk of politico-social eruptions with unforeseeable consequences for the respective countries and for the future of European integration. The rise of extremist and xenophobic parties, increasing anti-EU populism and anti-euro sentiments, the emergence of nationalistic chauvinism, national stereotypes, historical resentments, and the intensification of an over-simplistic and harmful blame game between Member States are serious causes for concern.

These anxieties have since 2012 led to a number of policy responses: the end of public speculation about a possible Greek exit from the euro; the decision to give France, Greece, Spain, or Portugal more time to implement structural reforms and to reach deficit targets, provided that they remain firmly committed to those objectives; the public discussion about fiscal multipliers triggered by the public recognition from two leading economists of the International Monetary Fund (IMF) – Olivier Blanchard and Daniel Leigh – that their institution (and others) had misjudged the negative impact of fiscal consolidation on European economies; and modest attempts at EU level to spark growth and counter (youth) unemployment. All this indicates that European and national policy-makers – also in countries less hit by the crisis – are out of self-interest willing to do more to prevent a further social and political destabilisation in individual and between Member States with potentially incalculable negative effects at national and European level.

However, EU leaders have so far not been able to deliver a convincing and comprehensive response to the key challenge, i.e. to stimulate growth and jobs especially in the hardest hit countries. Their main assumption or rather hope (!) is that the economic situation will improve towards the end of 2013 and in 2014 due to increasing demand from outside Europe (especially China) and due to an expected positive impact of the return of confidence in the future of the euro. In addition, there is an assumption that structural reforms in many EU countries will eventually pay off and improve economic development and employment, and that, in the meantime, ways must be found to buy time and cushion the negative effects of the unavoidable public expenditure cuts and reforms.

Giving countries more time to consolidate national budgets, a stronger focus on fighting (youth) unemployment (including i.a. the Youth Opportunities Initiative and the Youth Guarantee Scheme), the promotion of investments in crisis-hit countries through the reallocation of structural funds, the increase of the European Investment Bank's (EIB) capital, the introduction of Project Bonds aiming to stimulate capital market financing for large-scale infrastructure projects, actions aiming to complete the Single Market, the multiple reductions of interest rates through the ECB, a recapitalisation and cleaning up of struggling banks and other steps to overcome financial fragmentation – all these measures point in the right direction.

What to expect in the months to come? – no major breakthroughs, no new grand initiatives, and all eyes on Germany

However, there are no guarantees that they will be effective and that success will come quickly enough to avoid a further escalation of the situation in the hardest hit countries. In the meantime, the EU will – at least until the end of 2013 – remain stuck in a 'lets-wait-and-see' mode and one should thus not expect any major breakthroughs or grand new initiatives in the upcoming months because of two main reasons.

First, the fact that the existential pressures on the euro have been significantly reduced has undermined the readiness of EU governments to take swift decisions or put forward new radical proposals. This does not mean that there will be no progress on issues related to some of the less contentious questions surrounding the creation of a banking union or the improvement of existing and the introduction of new instruments aimed at enhancing EMU governance and the competitiveness of Member States. The latter could include practical improvements concerning the European Semester, progress towards the introduction of "bilateral contracts" between the European Commission and Member States, the establishment of a new "solidarity mechanism" providing financial means to support structural reforms and innovations aiming to increase competitiveness, or means to enhance *ex ante* coordination of major national reforms. However, substantial progress and final decisions on more sensitive issues such as the setting up of a Single Resolution Mechanism or the details of a potential direct recapitalisation of banks will take more time.

Second, the upcoming months will continue to be overshadowed by the wait in Brussels and other capitals for the outcome of German federal elections in September 2013. It is still impossible to make firm predictions about the outcome of the elections or their potential consequences for EU affairs. Many outcomes seem possible: the current conservative-liberal coalition of CDU/CSU and FDP led by Chancellor Merkel might be able to remain in power, provided the conservatives do not lose support in the final months and the liberals enter the Bundestag. Yet, public opinion polls suggest that a majority of voters would prefer another coalition government led by Angela Merkel. Such an alternative coalition could include either the social democrats (SPD) in a grand coalition (the alternative preferred by most Germans) or a coalition between the CDU/CSU and the Greens (Bündnis 90/Die Grünen), although the latter seems less likely due to (increasing) internal opposition on both sides. At the same time, one should not exclude another alternative: if support for Angela Merkel and the CDU/CSU falls in the final run-up to the elections, as happened both in 2004 and 2009, and if the social democrats are able to recover some ground, both the SPD and the Greens will opt for a coalition led by Peer Steinbrück (SPD). The chances for this option could increase if the newly formed anti-euro party – Alternative für Deutschland (AfE) – is able to attract parts of the electorate that otherwise would have voted for the CDU/CSU, even if the AfE itself is not likely to overcome the 5 per cent hurdle necessary to enter the Bundestag.

It is even more difficult to make sound predictions about the consequences of the next German elections for EU affairs, although some assumptions can be made: a new German government – even if it is not led by Chancellor Merkel – is unlikely to make radical changes when it comes to EU affairs. However, it will be politically easier for any new government with a fresh mandate to take certain 'difficult' decisions concerning, for example, the Single Resolution Mechanism, a (limited) direct recapitalization of banks, or the setting up of a new financial instrument intended to support specific structural reforms in EU/euro countries particularly hit by the crisis. A government including the SPD and/or the Greens might be more willing and politically able to stimulate domestic demand and push forward a substantial, well-targeted but temporary European stimulus package (but without permanent transfers!), especially if the latter aims to specifically fight (youth) unemployment. Going one step beyond, a coalition government involving 'only' the SPD and the Greens might be more open to ideas aiming to put in place a systemic instrument able to provide countercyclical financial support – something along the lines of the "shock absorption capacity" proposed in the four Presidents' report from last November.

With respect to the EU's long-term politico-institutional future, it is by no means clear whether the next German government will be willing to go (well) beyond the limits confined by the current EU Treaties. Indications are increasing that the next German government might support targeted reforms including limited treaty amendments, but that Berlin will shy away from innovations that might require another major EU reform exercise involving a third European Convention after the EP elections in 2014, fearing the consequences of potential failure. Finally, chances are high that the climate for a *rapprochement* between Paris and Berlin will – independent of the ballot's outcome – be more promising after German federal elections, as both sides will most likely be more inclined to compromise.

In more general terms and by means of conclusion, it seems likely that EU governments, EU institutions and especially the ECB will be able to keep the financial and fiscal dangers resulting from the crisis under control. However, the socio-economic situation in the countries most affected by the crisis is not likely to improve in the immediate future. As a consequence, policy-makers at EU and national level will have to further intensify their efforts to cushion the negative effects resulting from a years-long recession and unbearable high levels of unemployment.

The experience since 2010 has repeatedly shown that the readiness to be courageous and do something ambitious depends on the magnitude of the challenge. Today, it is not clear how far leaders in both stronger and weaker EU countries will be willing and able to go. But two things seem certain: the immediate and long-term effects of the socio-political dimension of the crisis should not be underestimated and this time around it is mainly up to governments, individually and collectively, to rise to the task. Contrary to last September, there will be no actor equivalent to the ECB able to act swiftly and decisively enough to avert a potential deterioration of the crisis in case things should politically get out of control in one or the other Member State or between EU countries.

About the Crisis Observatory

In the context of the worst economic crisis in the history of post-war Greece and the wider European debt crisis, initiatives for the systematic and scientific documentation, study and analysis of the crisis in both Greece and Europe are sorely needed.

The Crisis Observatory aims to answer this call. The Crisis Observatory is an initiative of the Hellenic Foundation for European and Foreign Policy (ELIAMEP), with the support of the Stavros Niarchos Foundation.

Its primary objective is to become a central hub for information, research and dialogue for both the Greek and European crises. The Crisis Observatory's guiding principle is the presentation of new research, policy proposals and information, which are based on solid arguments and empirical evidence, with a view to improving the level of public discourse about the crisis. In order to achieve this objective, the Crisis Observatory's work is organized around three central pillars:

- The provision of educational material with a view to enhance the ability of the average citizen, who often does not have a good hold on economic issues, to understand basic parameters of the crisis.
- The provision of serious, evidence-based and representative, in terms of subject focus and theoretical/political approaches, information about the crisis.
- Intervention in the public discourse about the crisis, through the creation of a venue for the free expression of different views and policy proposals promulgation of new research about the crisis.

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