Does Europe Need a New Grand Bargain?

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It is a great pleasure, and indeed an honour, to be invited to speak at the Euroforum conference in the presence of Mr Herman Van Rompuy, President of the European Council. This year's subject, namely the European social dimension, has acquired new prominence in the context of growing economic and social divergence between and within our countries as a result of the crisis, following a more long-term trend of rising income inequalities in the developed world in general.

Tonight, I should like to invite you to look at the bigger picture. We all know that Europe has gone through a long and deep crisis, and the end is not over yet. It is arguably the worst crisis we have experienced since the very beginning of European integration back in the 1950s. And in the eyes of many observers, it looks like an existential crisis testing the limits of the joint management of interdependence in times when economic divergence is growing and nationalism is rising, also testing the limits of European solidarity as the private increasingly trumps the public in our societies.

The good news is that, so far at least, we have avoided the worst, meaning the demise of the euro which would have had incalculable economic and political consequences within the currency union and beyond. We have avoided the worst very much against the expectations (and shall we say, wishes) of all kinds of doomsayers. On the edge of the precipice, Europe's political leaders have shown a strong instinct of survival. Luckily, I should add, for all of us.

All kinds of 'unthinkables' have happened to save the euro. The list is indeed long and impressive ranging from big national 'bail-outs' that dare not speak their name because they were not supposed to happen, large packages of financial assistance that have set new records in international financial history, extremely painful adjustment programmes for the countries in trouble, and new stringent forms of fiscal and economic policy coordination for all euro members.

Meanwhile, the European Central Bank, the federal institution par excellence, has been forced to stretch continuously the limits of the legal constraints imposed on it by Maastricht trying to act as the saviour of last resort of the euro. A banking union, as the next most important step after the creation of the common currency, has also been agreed upon, although it will take several years to install, especially as regards the resolution regime and a common deposit insurance scheme.

The bad news, however, is that the price we have paid is very high in both economic and political terms. European economies have been languishing, and some have indeed imploded. Real GDP of 2007 for the euro area as a whole will not be recovered before the end of 2015 at the earliest: a lost decade in other words. Unemployment is very high, and in the South of Europe it has reached levels that would have been unimaginable during peacetime. Youth unemployment has gone up to stratospheric levels in parts of Europe. It is unlikely to come down fast, thus raising the spectre of a lost generation as well.

Economic divergence has also grown a great deal and Europe has been divided between creditor and debtor countries. Anti-systemic and anti-European parties have grown, and this was confirmed in last May's European elections. Popular support for European integration has reached a historical low.

In a crisis that was US-born but soon turned itself into a systemic crisis of the euro area, the comparison with the United States in terms of economic performance is hardly flattering for us Europeans. Surely, the crisis was big and we were unlucky in the sense that the first big test for the common currency came after the bursting of the biggest international financial bubble since 1929.

We were, of course, also ill-prepared. At Maastricht, we had agreed to create a common currency but without the institutions and rules that would make it viable in the long run. A currency without a state (or even some kind of state): a contradiction that had been pointed out by Tommaso Padoa-Schioppa among others early on. Build it as you go along would be, perhaps, the benign explanation for the economic and monetary union agreed at Maastricht. There are surely other explanations as well.

The crisis also revealed all kinds of problematic children in the European family: countries with outdated economic development models and dysfunctional political systems, countries that had lived in the years of plenty on borrowed time and money. Alas, with the outbreak of the crisis, time ran out. My own country, Greece, is, I am afraid, a well-known example. But surely, it is not the only one as most people discovered, or were simply reminded, while the crisis deepened and spread to others.

The crisis was big and our common institutions were weak and not geared to strategic thinking. The crisis was also experienced in very different ways within the euro area, thus leading to a wide divergence of interests and perceptions among member countries. Trust was low and the politics turned, perhaps unavoidably, toxic. Last but not least, the economic strategy gradually adopted to deal with the crisis proved to be faulty at best, although this is not the view yet shared by everybody.

Austerity and reform became the policy slogan in Europe in crisis, and the tone was set by creditor countries. But if many countries resort to fiscal contraction simultaneously in times of panic when the private sector, including banks, is also trying to reduce its debt exposure after a bubble bursts, the probability of ending up in a vicious circle of austerity and recession is very high. And then, the reduction of public and private debt as a percentage of GDP becomes, in part at least, a self-defeating exercise.

This is precisely what happened, albeit to a different extent, in debtor countries and the euro area as a whole. Meanwhile, the loosening of monetary policy has usually come late and has not been enough, although admittedly the ECB has played the most decisive role in preventing the disintegration of the euro area until now.

Greece served as a convenient alibi for the overall economic strategy adopted. Greece's crisis was indeed mainly the result of fiscal profligacy and general mismanagement, and she was the first country that markets zoomed upon when euphoria turned into panic.

Yet, the crisis in the euro area as a whole has had much more to do with privately created bubbles than with fiscal profligacy. The Maastricht construction had not been designed to deal with such bubbles. And when they did burst, we kept for long in denial. I am told that in Dutch, as well as in German, the word for debt and guilt is the same. Other languages draw a distinction between the two. But are borrowers really the only ones to blame when a bubble bursts? And what do you do when debts become unsustainable?

Allow me here to open a parenthesis concerning structural reform which is both necessary and long overdue, in some countries of course more than in others. Reform often challenges vested interests that put up strong resistance to prevent it. You therefore need effective political leadership to overcome this resistance. But the task becomes even more difficult when the economy is imploding, while the benefits resulting from reform inevitably take time to materialize.

Let me add a further qualification. Some reforms, notably in labour markets, have important distributional consequences. For example, as a result of the labour reforms introduced by Chancellor Schröder, Germany has become more competitive but also internally more unequal. This is not an easy political equation to solve. But at least, let us not pretend that all reform is for the best in the best of all possible worlds.

I believe that growing unhappiness about the state of Europe and European integration in particular is not simply the product of the crisis we have been through in recent years. It has deeper roots. With successive rounds of widening and deepening, the European project has become much bigger, more intrusive and less inclusive internally, while external competition intensified in a rapidly globalising world.

Integration has reached the so-called nooks and crannies of our societies, as the British more often than others like to remind us and sometimes for good reason. People feel increasingly cut off from decisions that directly affect their everyday lives, decisions taken by institutions they do not identify with or feel able to influence in any way. And even worse, many see themselves as losers in this long economic transformation linked both to technological innovation and globalization. It used to be growth and rising inequalities for some time, but growth is no longer.

With prolonged economic stagnation and high unemployment in many countries, the number of losers, or potential losers, in many of our societies keeps rising. They turn anti-establishment, and in their eyes, the EU is part of the establishment they have come to resent. Add to that the widespread feeling of injustice in our societies, because the distribution of pain after the crisis hardly corresponds to the distribution of gain before the bubble burst, and you will not be surprised that large numbers of Europeans are today manifestly unhappy. Love for Europe has also suffered as a result, especially since regional integration came to be perceived increasingly as a zero- or even negative-sum game.

Yet, support for the euro remains high, most notably in the beleaguered countries of the periphery. Does this mean that popular discontent has not reached the common currency? It would be rather strange after all, since the euro has been at the centre of the crisis. I put forward an alternative explanation, which seems to me to be more plausible, namely that support for the euro is more out of fear of the alternative rather than love for the common currency.

The large majority of Europeans, in both creditor and debtor countries, remain convinced (and rightly so, I think) that the demise of the euro, or the exit of individual countries, would be much worse than the present unhappy state. This is mainly what still keeps us together, and also what is still left of the old political glue after many years of being so closely tied together. It is an unhappy equilibrium though, unstable and very much prone to accidents.

What are the prospects for the future? So many hopes have been pinned on growth that, like the tide, would come and help lift all boats from the sand (and national economies out of the recession). But growth in Europe remains elusive.

Arguably, the worst is now over: the euro system is better armed to deal with adversity in the future, markets have gone back to normal (or almost, while perhaps building another bubble), countries are slowly coming out of painful adjustment programmes and return to markets to borrow, structural reforms have been taking place, and fiscal consolidation has made significant progress in several countries, including mine which has set a new record of budget deficit reduction in a short period of time.

Europe is getting increasingly fit for purpose – and for globalization – so the advocates of austerity and reform argue. And they ask for more of the same, especially among the laggards. The category of laggards now includes a key member of the European project, namely France, which means that the crisis has reached the core. A reformed and financially strong Europe is a pre-condition for sustainable growth, so the preachers of economic virtue repeat again and again. They are the ones who have been calling the shots until now. They may be right, but they tell only one part of the story.

Critics of the prevailing orthodoxy, to be found more in debtor countries and on the left of centre of the political spectrum more generally, remind us that the euro area is courting with deflation, which makes adjustment for the deficit countries and the sustainability of accumulated debts much more difficult, if not impossible. Growth remains very slow and uneven at best. The large numbers of unemployed will be unable to find jobs anytime soon, public debt is much higher than it was in the beginning of the crisis, private debt also remains very high (and not only among the usual suspects in the periphery of Europe) and banks are still trying to deleverage. Those critics are, therefore, much less sanguine about the economic prospects for Europe.

They argue, and I would agree, that there is urgent need for a more active use of fiscal and monetary policy to boost demand and thus create the conditions for growth and moderate inflation, which are both needed to lift Europe out of the crisis. This should include some fiscal loosening mostly geared towards investment. There should also be a more symmetrical adjustment between deficit and surplus countries, since the burden of adjustment has so far fallen almost exclusively on the deficit countries with a deflationary impact on the economy. In other words, some countries today have a much wider margin of manoeuvre than others, and they should be strongly encouraged to make the best use of it.

We need a better mix of fiscal and monetary policy. The ECB would be expected to act more aggressively by pumping extra liquidity into the economy through direct asset purchases, thus following the example of the US Federal Reserve and the Bank of England. The problem of undercapitalized banks carrying the burden of many bad loans needs to be dealt with sooner rather than later, and the ECB could also provide some extra breathing space for countries with a very large public debt.

The main message I am trying to get across here is that we need to restore some balance between the two sides of the political and intellectual divide about how to manage the crisis. Under the circumstances, restoring the balance would in itself constitute some kind of grand bargain for Europe. In other words, we need to combine wide ranging programmes of national reforms with a more active use of fiscal and monetary policy to help raise the European economy from its torpor and turn European integration once again into a positive sum game.

There are already many analysts, and important policy makers as well, calling for a policy shift in this direction. But resistance remains strong in some quarters, in Berlin in particular, because of a different view of how the economy works, because of short-termism or simply because of lack of trust (not totally unjustifiably perhaps) that the others will be willing or able to deliver their side of the bargain. If and when Europe decides to move in this direction, the danger is that it will be again too little and too late.

In a long essay I wrote in March this year, entitled *The Unhappy State of the Union: Europe Needs a New Grand Bargain,* I tried to argue the case for a grand bargain. And I was fortunate enough that leading European think tanks decided to circulate it in six languages.

In that paper, I argued the case for a more balanced economic strategy, as it has been just outlined, but I also went much further. The euro has become a make or break issue in Europe. It has also become the centrepiece of the European project. I believe that, as it stands today, euro governance is neither effective nor legitimate. It is also a system operating on the borders of legality as set by the existing treaties.

For the common currency to survive, euro governance will need more effective policy instruments, stronger common institutions, and an executive that is democratically accountable and able to act with discretionary power. This will need to be balanced against a set of constraining rules on national policies which are necessary as well.

The contradiction of a currency without a state will need to be resolved, although this can only happen gradually. A monetary union cannot survive in the long run without some fiscal union and a legitimate political base on which to rest. A modest budget for the currency union with automatic stabilisers and transfers, preferably with its own resources, financial incentives linked to national reforms, some joint issuing of debt, the mutualisation of risk in relation to the banking system: they are all necessary pre-conditions for a viable common currency. And they are not all that controversial.

Of course, they cannot all happen tomorrow. But the first steps need to be taken soon and the road map agreed upon. The promise of a better future, which always remains distant and vague, is not good enough in times of crisis. And this is, arguably, the mother of crises we are going through in Europe today. Some of the fundamentals of the European project are at stake.

I believe we need a new euro treaty that should be able to face the test of democracy in member countries, on the condition that no country has the right to stop others from going ahead and that each national parliament - and/or citizens when a referendum is called - is presented with a clear choice, namely in or out. This means that a qualified majority of countries and citizens would be required for the new treaty to come into force. The fiscal compact treaty could provide a useful precedent.

We should also make provisions for those countries interested in ratifying the new treaty but not yet ready to join the euro, while also allowing for more flexibility and differentiation for countries that choose to stay out but still want to remain under the bigger EU roof. And it goes without saying that rights should always go hand in hand with obligations.

Sure, the European project is not just an intergovernmental bargain; it has important implications for the domestic economic and social order. Today, social contracts are under strong pressure – in some countries, they are being literally torn apart. The feeling of injustice and disempowerment is strong among many citizens.

This brings me back to the subject of today's Euroforum conference. I believe Europe needs a social and caring dimension if it wants to once again win the hearts and minds of large sections of society in times when there is not all that much to go around. Given the circumstances the offer will, of course, have to be both modest and well-targeted.

European solidarity and welfare reform, rationalization at the national level within a broad framework of jointly agreed objectives and with European instruments in the role of facilitators, could provide the basis for a fruitful division of labour, and hence also become part of the overall bargain. A European unemployment insurance scheme, complementary to national action and subject to strict conditionality to deal with the problem of moral hazard, may be part of the overall bargain, as well as an integral part of the system of automatic stabilisers within the euro budget.

The initiative for a new grand bargain can only come from the strong, not from the weak. As we all know, Germany has emerged from this crisis as the indispensable country, although itself it often seems reluctant to lead. Of course, Germany cannot on its own act as the white knight that saves the euro-maiden in distress. Germany's partners will have to deliver their side of the bargain.

But again, it cannot all be just an intergovernmental affair. A new European grand bargain will require a *Große Koalition* (Grand Coalition) of the main political families in Europe recognizing the value of the European project but also the need to give it new shape and form in a rapidly changing world.

I am sure that by now several people in the audience are agitating. Will the speaker finally wake up and stop dreaming, they probably wonder. It is all too unreal after all, isn't it? Who and how will explain the complexities of European integration when mass politics turns into populism and simple messages? And how can you restore trust between countries and governments? These are some of the questions they are likely to ask, and they are indeed very legitimate questions.

Hard realists will also remind us that the political appetite is simply not there for such a leap forward and for further transfers of power to Brussels and supranational institutions – and again, they are most probably right. Economics pushes towards more integration, including policy integration, and politics resists. Don't go for the leap forward, because you risk injuring yourself badly, they will warn us.

My brief answer, because the time has come to conclude, is twofold.

First, appetite seems to me to be a relative thing. It very much depends on what is on the menu. Instead of wondering whether and how politics will adjust to economic reality, we should ask a more relevant question, namely what kind of politics and what kind of policies might help to reconcile economic with political reality in Europe today. Not any kind of Europe, in other words. We need to be bold when faced with a Gordian knot. It is all about seizing the moment and using the right instrument.

Second, if we are indeed unable to move to the next stage of integration, thus creating the basis for a functional Union in political, economic as well as social terms, we should perhaps begin to try to reconcile ourselves with the risk of major accidents happening along the way. And we should also try to reconcile ourselves with the prospect of a Europe that remains weak and internally divided, an ageing and declining continent increasingly irrelevant in a rapidly changing world and with a highly unstable neighbourhood. It is not a nice prospect at all, but some of the signs are already there.