Chapter 12

Conclusion: The Future of the Euro

Possible Futures, Risks, and Uncertainties

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European Political Economy and the Importance of Embedded Institutions

In December 2001, on the eve of euro notes and coins going into circulation, Romano Prodi, then president of the European Commission, reflected on Europe's historic leap toward monetary unification in an interview with the *Financial Times*: "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."[1] The crisis came just under a decade later; a myriad of new economic policy instruments were introduced; and Europe's single currency was pulled back from the brink of collapse in the summer of 2012. The euro survived its first serious crisis. What is more, the Eurozone continued to expand, adding new member states both during and after its debt crisis. Estonia joined in 2011, Latvia in 2014, and Lithuania in 2015. Many observers concluded that Europe's political elites, once again, had gambled and won: the euro was here to stay.[2]

Nevertheless, despite all this exoneration and apparent success, by the summer of 2014 the Eurozone's member states seemed trapped in a rather unhappy marriage. Europeans' trust in their supranational institutions was at an all time low,[3] and Euro-

skeptic parties across the Continent recorded their best ever results in the elections for the European Parliament in May 2014.[4] The northern member states found the periphery bailouts hard to swallow, while the southern member states openly resented the uneven imposition of austerity and external demands for structural reform. North and South seemed to be living together despite "irreconcilable differences" as recession made way to stagnation and, in some cases, depression.

Yet the prospect of an amicable divorce, even in the case of depression-battered Greece, was not that appealing. Unlike hard currency pegs, where the original currency remains in circulation, the euro physically replaced all the prior currencies in circulation. Whereas pegs can be broken, unilaterally replacing the euro with a national currency means printing anew. Not only will capital flee as it anticipates this process, import inflation would quickly skyrocket if redenomination occurred. Furthermore, as Greece found out to its despair, when you do not have much of value to sell to the rest of the world, the boost to exports that redenomination should achieve in theory may well fail to materialize in practice. In such a world, once you are in, you stay married.

American Lessons for a European Polity?

There were prior political reasons for such precommitments. One of the main attractions of Economic and Monetary Union (EMU) during the 1990s—especially for Paris-based elites—was not only the importation of Germany's policy credibility and culture of stability, but also the notion that the euro would soon earn Europe the privileges that come with being an international reserve currency. The euro could, in

principle, challenge the dollar's monetary hegemony, and Europe's economy would be the main beneficiary.

Ever since the abandonment of the Bretton Woods system of fixed exchange rates, Europe's economies had seen significant currency fluctuations among them during the 1970s and 1980s, more often than not caused by changes in the US Federal Reserve's monetary policy. A common currency, the reasoning went, would remove intra-European exchange rate risk once and for all, and would end the perennial instability of its currency markets. Indeed, as the Prodi quote above suggests, European elites saw EMU as the beginning of a larger process that would eventually lead to a genuine European Constitution—not unlike America's Constitution drafted in 1787 in Philadelphia—that would result in a truly federal European polity. The Europeans, however, could have learned a thing or two from the American experience, if they had paid closer attention to the actual sequence of events in that prior case. Perhaps even more important, and as the analysis of this book makes plain, they should also pay more attention to the concepts of "institutional embeddedness" and "embedded currency areas" developed by Kathleen McNamara in Chapter 2 of this volume.

McNamara drew our attention to the political bargains, cultural norms, and institutional interdependencies that made prior currency unions work, distilling for us the minimum requirements of what she termed an "embedded currency area" (ECA). Those were "(1) a legitimated generator of market confidence and liquidity, (2) mechanisms for fiscal redistribution and economic adjustment, (3) regulation of financial risk and uncertainty, and (4) political solidarity."[5] As McNamara shows us, such embedded institutions tend to evolve over time, preceding and making possible the establishment of

later more obviously economic institutions. The United States serves as a case in point. While the US started out as a political union, the European Union hoped to end as one. In the US, political integration preceded economic union, while in Europe, economic integration was the means to arrive at political union.

As Randall Henning and Martin Kessler noted in an essay for the Brussels-based economics think tank *Bruegel*, rather than ending with one, the US actually started with a limited fiscal union and a common debt instrument.[6] In order to further tie together the nascent federal union politically in 1790, Alexander Hamilton, America's first Treasury Secretary, insisted that the federal government assume 25 million dollars in state debt incurred by the 13 colonies to finance the revolutionary war, and then added it to the existing federal debt owed to France ($11.7 million) and to domestic investors ($42.1 million). Twenty-five million dollars was not a trivial amount at that time, since US nominal GDP was estimated to be around 187 million dollars.[7] Later, the "no-bailout" norm among states in the union was established in the 1840s, once the US was firmly established as a political entity. The US single currency (the "greenback") was introduced another two decades later by President Abraham Lincoln during the US Civil War in 1863 as a means to eventually bind the South closer to the North. A common central bank—the Federal Reserve Board—followed much later, in 1913, while the American banking and financial union, including federal deposit insurance and joint and several liability, was only completed in the 1930s, under the New Deal legislation of President Franklin Delano Roosevelt.[8]

In short, the Americans started with a political union and a federal economic government, complete with a federal debt instrument as well as limited tax levying

capacity at the political center. Only much later did they introduce a common currency, a single central bank with the sole right to issue new money, and the equivalent of a banking and financial union. In terms of McNamara's criteria for a successfully embedded currency area, the US got there with the sequence (4), (1), (3), and (2).

The European Union so far has followed a rather different sequence of institution building and political development. The European Economic Community (EEC) started with a customs union of six countries in the late 1950s, agreed on a Common Agricultural Policy in the 1960s, and expanded by adding a few more states in the 1970s and again in the 1980s. The customs union was significantly deepened, becoming a common market with free movement of capital and labor through the Single European Act (SEA) signed in the mid-1980s. With the Maastricht Treaty of 1992, it established a European Central Bank (ECB) in the mid-1990s, followed by the introduction of the single currency, the euro, in 1999 together with a common monetary policy. It was only after two full years of euro crisis, in June 2012, that the idea of a banking union was introduced. A single supervisory mechanism for Europe's systemically important banks was agreed to in late 2013, and went into effect in the autumn of 2014.[9]

Yet, despite these new institutional innovations, Europe today remains without anything resembling a true fiscal union or an economic government, the rules of the "Fiscal Compact" notwithstanding. It lacks a common debt instrument—the so-called Eurobond—and is still far away from a political union that would have the same democratic legitimacy among the citizens of the European Union as the US federal government has with Americans. In other words, the euro as a currency remains fundamentally dis-embedded, in McNamara's terms, from its broader social and political

realities, which for the most part in Europe are still based at the level of the individual nation-state.

As no prior currency union composed of multiple large countries seems to have survived without some sort of political union, the importance of McNamara's checklist of what we term "institutional minima" is something European policymakers would do well to keep in mind. Multistate economic projects need to be more fully embedded in existing social and political institutions if they want to be successful in the long term. This is something that America's Founding Fathers seemed to have known instinctively from the very beginning. To date, it does not seem to have penetrated the top echelons of Eurozone policymaking.

Does it then follow that in the absence of such embedded institutions the euro is doomed? Not necessarily, at least not in the short to medium term. Europe and its single currency can continue to muddle through as it has done over the past half decade. The longer-term future of the euro, however, will depend on whether the European Union is able to build the social and political institutions necessary to provide those minima. The chapters in this book suggest both what those minima are and, if built, what possible futures those institutions will face over the next five to ten years.

The Euro's Problem, Experience, and Future: What Have We Learned?

In the first section of the book we explained *the euro problem* as the result of a series of "forgotten unions" that built deep fragilities into the currency's overall architecture. The

three forgotten unions of the euro—elaborated on in Jones's Chapter 3, Jabko's Chapter 4, and Schmidt's Chapter 5—are a financial as well as a banking union, institutions of economic governance including supranational fiscal tools, and more effective institutional mechanisms that promote political legitimacy and social solidarity. The main euro problem therefore is, and remains, one of missing "systemic" institutional embeddedness, rather than a lack of "national" competitiveness, labor mobility, wage flexibility, or fiscal restraint.

Erik Jones defines the euro's forgotten financial union as the lack of institutions to manage and regulate cross-border financial flows in a single capital market, which includes a central bank that can act as a true lender of last resort for both Europe's sovereigns and its pan-European banks, as well as a common debt instrument or Eurobond. For Jones, the absence of this financial union was always enough to bring some kind of crisis about, with or without the euro.

Nicolas Jabko added the missing institutions of economic governance to the mix, highlighting the largely unanticipated contradiction between the concern for traditional sovereignty at the national level and a new conception of supranational sovereignty at the European level. He concludes that as long as national elites remain reluctant to see their own powers diminished, the euro's design will remain unfinished and fragile. At the same time, however, those elites cannot easily ignore deeply entrenched notions of sovereignty that resonate with nationally specific ideas about power, liberty, and popular legitimacy.

This latter point is exactly what Vivien Schmidt sees as the final and crucial forgotten union—the political and democratic one that binds all the others together:

fiscal, economic, financial, and monetary. For Schmidt, Europe's monetary union lacks legitimate political support mechanisms—at all three levels of democratic input, throughput, and output—as well as long-standing institutions and ideas of intra-European solidarity. The euro's sustainability hence depends on whether it can attract similar democratic support and levels of legitimacy in the future in comparison to what the nation-state enjoys in Europe today.

In Section II of the book, we looked at *the euro experience* from the perspective of its four key member states: Germany, France, Italy, and Spain. Those four economies combined constituted more than 75 percent of the whole Eurozone's GDP in 2013, making them the euro system's principal players.[10] All four experienced both the decade that followed the introduction of the euro and the Eurozone crisis itself very differently. Germany started the 2000s as the "sick man of Europe." France began the decade as the accepted political leader of the Eurozone, while Italy recorded very modest growth rates, but saw its high debt-to-GDP ratio gradually decline. Spain basked in its newfound role as star pupil of the euro growth class. A decade later, after 2010, they all saw their respective roles transformed.

Having absorbed the fiscal brunt of reunification in the 1990s, and having seen its wage costs fall as a consequence for a decade prior to the introduction of the euro and a whole series of labor market reforms, Germany led the Euro pack in 2010 with fast growth and record low unemployment. Over the same period France slipped from being top dog to being a middle-ranking euro power, or "middle child," as Mark Vail puts it in Chapter 7, trying to reconcile itself to its new position as a core member state with periphery characteristics. Italy, through euro crisis contagion and the invention of

unflattering acronyms linking all crisis-hit Eurozone countries, found itself thrown into the periphery camp, while Spain suddenly went from *wunderkind* to problem child.

Abraham Newman, in Chapter 6, develops an historical explanation for Germany's actions during the euro crisis. Newman argues that Germany's disheartening experience with reunification, plus its ordoliberal tradition and stability culture, combined with the coincidence of its own labor market and welfare reform programs and subsequent economic recovery to determine Berlin's actions. Reluctant to embrace a crisis narrative of contagion risk or a lack of demand in export markets that would have facilitated a more activist or interventionist role, Angela Merkel's various governments played the role of "reluctant leader," adopting a narrative of moral hazard, as well as the need to abide by the rules and implement structural reforms as the only road out of the crisis. This resulted in Germany's preferred policies of austerity and structural reform as the only politically viable solution to the Eurozone's debt crisis, regardless of its dubious macroeconomic merits.

Mark Vail, in Chapter 7, compares France's fall from joint leader of Europe to having to play the role of any family's "middle child"—trying to play the mediator between the northern core and southern periphery member states. But in doing so, France embraces an internal contradiction—binding her economic fate and political prestige to following the preferred policies of Germany and the rest of the North while trying to remain committed, at least rhetorically, to her much-vaunted statist socioeconomic model prevalent in the South. Like most contradictory positions, and standard procedure for being a middle child, no one really cares, and you end up being ignored.

Jonathan Hopkin, in Chapter 8, rejects the standard narrative in both Italy and Spain that explains both countries' woes since 2010 as the inevitable result of greedy unions pricing themselves out of jobs during the boom years. Hopkin, by contrast, shows how the introduction of the euro led to wage stagnation in the Mediterranean countries' manufacturing sectors, which are those most heavily exposed to international competition. The introduction of the euro, however, did bring large gains to the more sheltered sectors such as construction and retail, as well as large parts of the public sector. In highlighting this facet of the crisis, Hopkin views the policies of austerity and structural reform in the South as political experiments in how far democracies are willing to go in terms of unemployment to return their economies to fiscal rectitude since they are targeting the wrong constituencies. Hopkin concludes that the jury is still out, but that the euro's future hangs in the balance. Its future will be determined by how southern Europe will continue to cope with the devastating effects of fiscal consolidation and jobless reform over a decade-long time frame.

In the third and final section of the book, we analyzed *the euro future* from three different points of view. First, how is Europe going to deal with its new German problem? If it is true that Germany's relative power in Europe increased substantially since the first decade of the 2000s, and if its policies have been part of the euro problem rather than the solution, what does that tell us about the single currency's future? Second, is it fair to say, as is often said, that Europe has always moved forward through crisis? And if that is the case, has the euro crisis led to the necessary institutional innovations that will make it possible for the Eurozone to both survive the present and weather future crises? Third, moving beyond Europe's internal dynamics and national political

economies, what does the future of the euro look like from an international perspective? What is the euro's place on the world's geopolitical chessboard, which includes, among others, a supposedly supposedly declining United States and a fast growing but fragile China?[11]

Wade Jacoby, in Chapter 9, explains how Berlin is torn between what he calls the "timing of politics" and the "politics of timing." On the one hand, Germany accepts its responsibilities as the Eurozone's most powerful member, but it still wants to make sure that bailouts only happen *in extremis*, and that the timing is such that any risk of moral hazard, where the delinquent is encouraged by the bailout to default in the future, is minimized. Time here is a virtue, as the longer one waits, the more the risk of moral hazard is reduced. Yet, at the same time, German politicians feel the pressure of their voters and therefore can only take significant steps in the direction of further integration if they feel that they have sufficiently prepared those voters. Time here is a vice, as any future intervention may be too late. The future of the euro thus depends on how Germany resolves this dilemma. Jacoby argues that this will determine whether we can expect to see any major systemic institution building in the near future, or whether the main governance structures of the euro will remain split between the supranational and national levels.

Craig Parsons and Matthias Matthijs, in Chapter 10, see the euro's future in a rather pessimistic light. They call into question the much-touted view that Europe always moves forward through crisis.[12] While they note that this popular notion of European integration is a reassuring frame for EU policymakers and statesmen, it is actually not borne out by the historical evidence. The European project has in fact almost always

moved forward when key players' positive visions of its future institutional development happened to collide, not as a technocratic response to widely perceived problems. Parsons and Matthijs see the euro crisis as Europe's first real crisis, and while the EU has made significant strides toward more integration, especially in the realm of the banking union, they conclude that it falls well short of addressing the single currency's core problem of absent institutional embeddedness.

In contrast, Eric Helleiner, in Chapter 11, paints a more optimistic picture of the euro's future by focusing on the international monetary system. He believes that the euro's future depends upon how long international financial markets will maintain their ostensibly voracious appetite for the US dollar, and what role China will play in the international monetary system as it gradually liberalizes the renminbi (RMB). While for now, the dollar reigns supreme, Helleiner sees a future of relative dollar decline, combined with a gradual rise of the RMB, which could be a positive development for the euro, ending in a perhaps more stable and multipolar currency system.[13]

One thread that all of these chapters have in common is an emphasis on the politics and political economy of the euro and of European integration. The irony of the euro crisis, of course, is that—from Greece and Spain to Germany and Finland—the crisis brought national politics back into the process of European integration: exactly the outcome the entire post-national project was designed to avoid. Those changing political dynamics, and how national politics will interact with EU level policies, will be crucial in determining which scenario will play out in the euro's future.

The Return of Politics and Possible Futures for the Euro

Four Crisis-Generated Changes That Matter for Europe's Future

Four significant developments in EU politics since 2010 were either the direct result of the euro crisis, or were cultivated and augmented by the policy responses to it, and all four are bound to have consequences for the euro's future. First are the rapidly changing dynamics between Germany and France. Traditionally, the Franco-German couple had functioned as the indispensable motor of European integration. To use former European Commission President Romani Prodi's metaphor, "each one was an equal cylinder in the engine, pushing when the other pulled."[14] That relationship has changed dramatically since the euro crisis. Prior to German reunification, the countries were of relatively equal size, and while Germany could boast a stronger and more dynamic economy, France could lay claim to the EU's political leadership given the catastrophic legacy of World War II for Germany. Yet while they constituted the "twin cylinders," Berlin and Paris always represented two fundamentally different visions of Economic and Monetary Union. While *ordoliberal* and *social market* Germany emphasized the supply side and the need for stability, rules, and fiscal restraint, *dirigiste* and *neo-Keynesian* France stressed the demand side and the importance of full employment, policy flexibility, and solidarity.

The euro crisis saw a noticeable shift in the balance of power away from Paris toward Berlin, which signals a more ordoliberal Europe going forward. While the Social Democratic government of Gerhard Schröder fundamentally reformed the German labor market in the first years of the 2000s, France saw few such reforms under both Gaullist Presidents Jacques Chirac and Nicolas Sarkozy. The latter had pledged a *rupture* for the French economy during his 2007 presidential election campaign, but found it much harder to deliver on that promise once in power. Already by 2006, Germany was

beginning to experience faster growth and lower unemployment, and the German government was eager to link this directly to the fruits of its *Hartz* reforms.[15] France, by contrast, saw continuing anemic growth and much higher unemployment, which the Germans then attributed to their lack of reforming zeal.

Once the euro crisis hit, both the media and financial markets scrutinized Angela Merkel's statements much more closely than the comments of either Nicolas Sarkozy or his successor François Hollande. The outcome of the seemingly never-ending series of EU crisis summits of that period largely depended on the stance of Berlin, not Paris. More often than not, the French and German governments would find themselves at odds with one another when it came to crisis responses, but Sarkozy would feel compelled to follow Merkel in her quest for fiscal consolidation and reform to remain relevant. Since 2012, French socialist President Hollande's efforts to shift EU policy away from austerity toward growth and fiscal stimulus proved to be largely irrelevant to actual policy. Again in Romano Prodi's words: "The Germans decide, and the French get to announce it during their joint press conference."[16] There is no doubt that the EU since the euro crisis has moved much more decisively in a "Germanic" direction.

The second big change, one that is particularly disturbing for the goals of the European project, was the return of the North-South gap in the EU. The euro crisis and the implementation of austerity and structural reforms reversed the progress made over the course of the 1990s and the first years of the 2000s in reducing the substantial differences in national income between EU members of the well-off North and the poorer South. Admission to the single currency was supposed to bring the younger (and poorer) democracies of Greece, Spain, and Portugal up to the levels experienced in the rest of

Europe. Yet exactly the opposite happened. While the ratio of per capita income (in constant prices) of poor Greece vis-à-vis much more affluent Germany had been steadily improving since the early 1990s to a high of 0.65 in 2007, it worsened again to 0.47 by 2013, a number much lower than the prevailing ratio in the early 1990s. And this was not just a Greek tragedy: the corresponding ratios for Italy's and Spain's per capita income vis-à-vis Germany's were at a high of 0.87 and 0.83 in 2007, and fell to 0.74 and 0.72 in 2013, respectively.[17]

Furthermore, the EU countries of the Mediterranean also experienced a conspicuous erosion of the strength of their democratic institutions and the effectiveness of their governments compared to those in the North since 2010.[18] This adverse evolution has brought new doubts to bear over the old EU mantra of an "ever closer union" and threatened not just the real economic gains that were made prior to the crisis, but also the quality of democracy experienced throughout the union. After all, if Brussels can veto a national parliament's budget, what is the point of electing that parliament in the first place?

Third, the euro crisis has displaced the traditional "community method" of decision-making in the EU in favor of what German Chancellor Merkel referred to as the "union method" in a speech in Bruges in the autumn of 2010.[19] With hundreds of billions of euros in bailout funds needed that were only available directly from the member states' budgets, it should perhaps have been no surprise that neither the European Commission nor the European Parliament on their own could have cobbled together a comprehensive solution. The commitment of those large amounts of taxpayers' money to the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)

naturally required oversight by national governments. Nevertheless, this meant that existing "community" institutions were largely sidelined in the decision-making process, with intergovernmental summits putting the European Council firmly in charge of crisis management.

Ironically, however, these supranational institutions may prove to be the long-term winners of the euro crisis. Between 2010 and 2014, the Commission gained sizable future powers in monitoring member states' fiscal policies through the so-called European Semester. The European Central Bank won large discretionary powers not just over monetary policy, but also over banking supervision and resolution. The European Parliament managed to stage a major coup against the European Council by launching a system of *Spitzenkandidaten* during the European elections in May 2014, in which Jean-Claude Juncker as the candidate to lead the Commission of the European People's Party (EPP) was de facto forced on Europe's heads of state and government in June 2014, despite UK Prime Minister David Cameron's desperate efforts to reverse the process and stop Juncker in his tracks. Yet, whether all of this activity adds up to McNamara's minimal conditions of an ECA remains very much in doubt.

Fourth, and finally, the euro crisis reintroduced political and legal tensions between nation-states and the supranational institutions of the European Union, constantly testing the limits of the integration process. As intimated in Section I, the Fiscal Compact, for example, was concluded as an intergovernmental treaty outside the EU Treaties, since Britain and the Czech Republic refused to sign it in December 2011. Once the 25 signatories adopted the treaty in March 2012, they were required to incorporate a balanced budget or "golden" rule into their constitutions, challenging the

nature and legitimacy of national constitutions. But the national judicial limits of European integration clashed with the need for system-wide Eurozone solutions most openly in Germany itself. The strongly independent Federal Constitutional Court (FCC or *Bundesverfassungsgericht*) in Karlsruhe had already called into question the democratic legitimacy of the 2009 Lisbon Treaty prior to the euro crisis. In the end, while there were no explicit constitutional objections against the Lisbon Treaty, Karlsruhe did impose limitations to future integration by identifying a number of state functions that were not amenable to integration and which were to be retained at the national level, especially in the realm of fiscal policy.

During the euro crisis, the FCC would rule over the legality of the ESM, the bond buying programs of the ECB, and at the time of writing, is still in the midst of a legal battle with the European Court of Justice (ECJ) in Luxembourg over the legality of the ECB's potential tool of outright monetary transactions (OMT). This legal aspect of the euro crisis added yet another layer of complexity to EU decision-making, periodically fueling uncertainty in financial markets. Given all of this, if Europe wants to build the "missing unions" to make the euro work for the long term, Germany will need to overcome some formidable political obstacles and change its constitution. Everyone else will have to reconcile fiscal centralization and effective national-level democracy, which is not an easy trick to pull off.

Competing Visions of Where Europe Goes from Here

There is no shortage of thinking when it comes to the future of the Eurozone. Both EU institutions and various think tanks around Europe have been looking at how to complete

the euro's unfinished institutional framework going forward, detailing the steps necessary to avoid another systemic crisis. All of those competing visions touch upon this book's central concerns, but mostly in an ad hoc and unsystematic manner, often mistaking what is economically and financially desirable for what is politically possible. Indeed, what all such proposals seem to have in common is a rather willful neglect of the role of politics in achieving a more complete EMU.

For example, both the European Council and the European Commission published blueprints for the Eurozone's future in late 2012. Herman Van Rompuy, president of the European Council, in close cooperation with José-Manuel Barroso, Jean-Claude Juncker, and Mario Draghi, published a first draft of their blueprint "Towards a Genuine Economic and Monetary Union" in June 2012, in advance of the crucial EU summit that allowed the ESM to directly recapitalize Spain's banking system.[20] What became known as the "Four Presidents' Report" had the advantage of being concise (the June draft was only 7 pages, while the December version was 18 pages), but falls well short of our minimum criteria for an embedded currency area.

While the "Four Presidents' Report" did call for a comprehensive banking union that comprised all European banks, including an effective resolution mechanism, it omitted common deposit insurance from its final draft, and only tentatively called for Eurobonds. The report defined fiscal union mainly as greater centralized budgetary controls and stricter rules—a necessary condition for Eurobonds—and only saw the need for a very limited Eurozone budget in the distant future. It paid lip service to the need for greater democratic legitimacy, mentioning the need for closer cooperation with national parliaments only in passing, omitting the need for any direct democratic choice over

policy. The Commission's own "blueprint for a deep and genuine economic and monetary union," released in late November 2012, added very little to the "Four Presidents' Report."[21] They referred to "Stability Bonds" rather than the politically more sensitive term "Eurobonds," but also only after more centralized fiscal controls were in place. It remained vague on the need for a Eurozone budget to absorb asymmetric shocks and mentioned the eventual need for a political union, but without any real specifics on how to get there.[22]

Unburdened by the need to govern, think tank blueprints are more ambitious in scope. *Notre Europe*, the Paris think tank chaired by former Commission President Jacques Delors, commissioned a report on "Completing the Euro" by the Tommaso Padoa-Schioppa Group, coordinated by Henrik Enderlein of the Hertie School in Berlin, which included EMU experts André Sapir, Paul De Grauwe, and Jean Pisany-Ferry.[23] The report, released in June 2012, goes much further than the blueprints of the Council and the Commission. The Padoa-Schioppa Group calls for a US-style Federal Deposit Insurance Corporation and an independent resolution agency to complement the banking union. They made a strong case for Eurobonds and a European Debt Agency to partially finance national budgets, though they also want stricter budgetary controls and stress the right of the Commission to limit the sovereignty of governments that break the rules and accrue too much debt. The report also wants a "cyclical adjustment insurance fund" to serve as the Eurozone budget and protect the currency union against asymmetric shocks, as well as a mechanism for sovereign debt restructuring. This report is obviously much closer to our own analysis. Yet as welcome as such suggestions are, they ignore the institutional, democratic, and electoral problems of getting there, as highlighted in this

volume by Jabko, Schmidt, Jacoby, and Hopkin. Unfortunately, you cannot assume away the politics you have in the hope to arrive at the economics you want.

Three more blueprints emerged from German, French, and British initiatives: the Glienicker Group, the Eiffel Group, and the Centre for European Reform (CER).[24] They all also go much further than the Council and Commission blueprints, in that they envision the need for a fiscal union, a Eurozone budget, and a more democratically legitimate political union, but they also stay close to their national traditions.[25] While the Glienicker group—which includes 11 German economists, political scientists, and jurists—makes no mention of common deposit insurance or Eurobonds, they do foresee the need for a limited economic government with a membership fee of 0.5 percent of GDP that could serve to provide unemployment insurance and public goods. They also emphasize the EU's right to limit the sovereignty of governments that borrow too much, but provide no mechanism for sovereign debt restructuring. Glienicker argues that to achieve their political agenda, "the euro area needs a new contractual basis of its own," a "Euro-treaty to replace previous piecemeal reforms."[26]

Hewing to the ideas that Mark Vail indentified in Chapter 7 as being quintessentially French, the Eiffel Group's report—signed by 12 French economists, political scientists, and legal scholars—proposes a Eurozone budget with full tax-raising and borrowing powers, Eurobonds, and a mechanism for sovereign debt restructuring. Eiffel wants "to construct a political Community which is democratic and based around the euro."[27] Their blueprint has an entire section called "method" that discusses the treaty changes and formal democratic procedures that will need to be implemented. But once again, whether those procedures are politically feasible is a question left unanswered.[28]

Finally, Philippe Legrain's report for the London-based Centre for European Reform, "How to Finish the Euro House," is probably the most ambitious and well thought out proposal, in terms of what needs to be done, that we have encountered.[29] It is also the most realistic when it comes to outlining what will actually happen, as opposed to outlining the future one would like to see. To work well, Legrain argues, the Eurozone needs to do four things: (1) try to prevent problems from emerging; (2) limit problems when they arise; (3) resolve problems "promptly, fairly, and safely"; and (4) be democratically legitimate. That is, the Eurozone needs to be properly accountable insofar as it embodies real democratic choices.[30]

This assessment comes closest to what we have defined as the outcomes of an embedded currency area in this volume. The CER report, however, is realistic enough politically to see that this will not happen overnight, if at all. Legrain suggests four possible futures for the Eurozone: a Germanic one, a technocratic one, a fiscally federal one, and a flexible (or de-centralized) one. Ideally, the Eurozone would move toward a fiscally federal Eurozone, but that is also politically the least likely option. Legrain fears that the current political trajectory of Europe has the Eurozone on a path toward a combination of a Germanic and a technocratic union, which falls far short of his ideal blueprint, and ours too, since it still treats politics as an error to be eliminated rather than a foundation from which to build. Legrain concludes that the current path Europe is on may ultimately lead the euro to disintegrate. However, though he is not hopeful, Legrain does allow for the possibility that a new crisis may "provide the political momentum to create a fiscally federal eurozone."[31]

From Blueprints to Black Swans: Europe's Possible Futures

Blueprints for the future of Europe are not like the blueprints for a building. The latter tend to correspond quite closely to what is actually built. The former usually end up quite far away from the future they purport to produce. The more complex the blueprint, and the further into the future it projects, the greater the risks and uncertainties that multiply within the structure. In order to make further sense of the future of the Eurozone given the many concerns raised in this book, we elaborate here on the future of the euro using the "black swan" metaphor originally developed by Nassim Nicholas Taleb.[32] Rather than chart still further paths, in part because we largely agree with Legrain's analysis, we use an extension of Taleb's metaphor in this final part of our concluding chapter to chart the likely economic, financial, and political threats facing the euro going forward. We envision three kinds of "euro swans"—white swans, grey swans, and black swans.[33]

First, *white swans* are events that present us with a potentially knowable economic or financial risk. There is a definable probability of them occurring, along with a reasonable estimate of their impact. Economic policymakers and individual market participants can hedge themselves against the impact of such white swans because insurance, to some degree, is possible. White swans are what former US Defense Secretary Donald Rumsfeld referred to as "known knowns."

Second, *grey swans* shade from risk toward uncertainty, but constantly wander between the two states. The future gets more complicated—and much more unpredictable—with grey swans. Grey swans happen when (mainly) political events—like a referendum, a national election, or an important parliamentary vote—about which we may know the actual timing but not the magnitude of their impact, upset other more

knowable variables. Grey swans may be less likely to happen than white swans, or at least the probability that they could be estimated accurately is lower, but they could potentially bring a much bigger shock to the system. They are both Rumsfeld's "known unknowns" and his "unknown knowns."

Third, *black swans* are those extraordinary events that have a completely unknown probability. These are Rumsfeld's "unknown unknowns," and are uncertain in the deepest sense of the word. We cannot know what they are in advance, but we do know that their impact will be devastating.[34] Black swans are particularly pernicious because they have no determinately related historical precedents, no set date, and elaboration from past data usually makes one more blind as to what is actually coming.

In sum, white swans are what we expect to see. They lie in the middle of the distribution of possible risks. Grey swans take us outside these parameters, out beyond our one or two sigma comfort zone. Black swans lie hidden deep in the tails of the distribution of possible futures.

Europe's White Swans

White swan events are a dime a dozen: a fall in Purchasing Managers Indices (PMIs), an upturn in consumer confidence, or a rise in the euro-dollar exchange rate despite ECB actions. They are trivial, in the sense that they are everyday occurrences, but that does not mean that they are unimportant. One example comes from Helleiner's focus in Chapter 11 on the international role of the euro. The fact that central banks outside Europe loaded up on euros prior to the crisis acted as a positive white swan for Europe insofar as it meant that during the crisis the euro-dollar exchange rate held up much better than a lot

of currency traders expected. This adding of euros to everyone's reserves created a prisoner's dilemma situation among central banks. If any of them tried to move out of euros, it would have triggered a run on the euro, which would have hurt them all. As such, it became in everyone's interest not to sell euros despite the currency's systemic crisis, and stability was unexpectedly assured.

Another example of a possibly positive white swan is the ECB's ongoing (at the time of writing) Asset Quality Review (AQR) of Europe's troubled banking system. Europe faces what might be called a "Goldilocks dilemma" in its attempt to reform its banking system.[35] As noted in this book by several of the authors, the European sovereign debt crisis was only triaged when ECB President Mario Draghi poured nearly one trillion euros of public money (LTROs) into the European banking system in December 2011 and March 2012. The result of all this cash hitting the banking system was to incentivize periphery banks to buy local sovereign bonds. Because of the yield compression this causes, if austerity policies are loosened and growth accelerates, then interest rates will have to rise. As that happens, the periphery banks holding all these bonds will see their asset base shrink in value as yields go up, bond prices go down, and their balance sheets become impaired. So growth cannot get "too hot." Given this, the ECB needs low rates, more LTROs, and a host of monetary tricks such as the introduction of negative deposit rates in June 2014 and the direct purchasing of covered bonds and asset-backed securities (ABS) as announced in October 2014 to allow the banks to clean up their balance sheets, one non-performing loan at a time, in an environment of relatively slow growth.

However, not only is such a process painfully slow, if growth is "too cold" these policies cannot work since only higher rates of growth will allow the banks to repair their

balance sheets as new "performing" loans replace their "non-performing" loans. Given this constraint, where growth can be neither too hot nor too cold, the AQR provides the ECB with a way to triage the worst offenses of the banking system without setting off a general panic. Bad bank solutions, such as Ireland's National Asset Management Agency (NAMA), may become more palatable to other states in the wake of the AQR. This could have a positive effect on the needed downsizing and recapitalization of the European financial sector, despite the Goldilocks constraint. Such white swans, should they occur, will be good for the euro's long-term future.

Europe's Grey Swans

Grey swans are more serious, in terms of magnitude, and tend to be more negative. We know something is coming, we just do not know when or what its magnitude will be. At a most general level, the politics of building embedded institutions is a grey swan. This is seen in Erik Jones's admonishment that without a full financial union, given the realities of cross-border banking by multinational banks that all effectively borrow their currency (since none of them prints the euro), some kind of accident waiting to happen is still there, despite recent reforms. We just do not know what it is yet, or how it will play out.

Jonathan Hopkin's Chapter 8 on Italy and Spain hints at another grey swan. Turning around Italy's debt position and cleaning up Spain's banks are arduous projects that could take a decade to complete. If the policy menu to achieve these ends is unending fiscal austerity, then quite apart from deflationary risks or GDP shrinkage, the sheer political sustainability of such policies comes into question. Asking people to vote once for austerity—even twice—is plausible if there is light at the end of the tunnel. If,

however, all that seems possible is the lengthening of the tunnel, then either democracy refuses the policy menu or the enforcers of the policy menu ignore democracy. The replacement of the democratically elected Greek and Italian leadership by veteran EU technocrats at the height of the crisis in November 2011 was no aberration. It was an inevitable product of this tension. If it breaks out again, which is likely, and democracy wins, which is also likely, all that remains in doubt is the magnitude of the shock it sends to the euro itself.

Wade Jacoby's insights on the timing of politics and the politics of timing in Germany also have great bearing here. While it is easy to blame Germany's austerity-fetishism for making the crisis a lot worse—and indeed there is merit in such a claim—the "democracy versus markets" problem highlighted by Hopkin in the South bites hard in Germany, too. Germany may be the Eurozone's biggest economy, but at a shade under 3.5 trillion dollars in GDP, it is only 29 percent of Eurozone GDP and a mere 8.75 percent of the value of the total asset footprint of the European banking sector.[36] As such, Germany can only be expected to swallow so much of everyone else's problems.[37] It is in this context that the timing of politics—the desire to minimize one's own risk of exposure to someone else's moral hazard—combines with the politics of timing—the "right" moment to sell a policy to the public—to create leadership that is likely always going to be insufficient to fully resolve the crisis and safeguard the euro's future.

Other grey swan–type events include popular referenda. Scotland voted on its independence on September 18, 2014 with 55 percent of Scots deciding to stay in the union. If it had decided to break away from the rest of the United Kingdom, the knock-on effects to European markets could have potentially been very large. It could have created

a shadow bond market for Scottish debt (amusingly called "kilt-edged securities") separate from British debt that would have weakened the British fiscal position. What was left of the UK could then have voted to leave the EU, just as Scotland would have been petitioning to get back in, all while using the Bank of England's money. The union seems safe for now, but Catalonia in Spain and Flanders in Belgium may well follow Scotland's example by announcing referendums of their own, bringing greater instability and enormous uncertainty over the status of their respective countries' large sovereign debt stocks.

Europe's Black Swans

By definition, black swans cannot be predicted, and past data, such as the analysis of this book, can make one less prepared for their arrival, rather than more. But having said that, there are a few imaginable "unknown unknowns" out there worth mentioning that are extremely underpriced and could yet generate huge risks.

The first is the "Treaty on Stability, Coordination and Governance," also known as the "Fiscal Compact."[38] This treaty came into effect in March 2012, mandating that national budgets be "balanced or in surplus"[39] with enforcement guaranteed by "preferably constitutional"[40] provisions embedded in national legal frameworks. In other words, parliaments are to vote away their last set of fiscal powers. Countries that produce "significant observed deviations"[41] from the numbers enshrined in the treaty will be fined. Furthermore, the so-called Six-Pack, consisting of five regulations and one directive, which entered into force in December 2011, includes a "Macroeconomic Imbalance Procedure."[42] This procedure allows member countries to have a maximum current

account deficit of 4 percent or a surplus of 6 percent of their respective GDPs. Given that imports and exports sum to zero, that surplus of +2 percent must be offset somehow. Either surplus countries reduce their surpluses, which they are not going to do voluntarily, or deficit countries have to run permanently tight policies to offset the surpluses, given the common currency. If this is the case, the Fiscal Compact and the Six-Pack themselves are risk generators of unknown value for the euro since they will more than likely produce macroeconomic outcomes in non-surplus countries that will add to the political instability that Hopkin highlights in Chapter 8.

A second black swan that lies hidden in the tail would be the unexpected return of a 1930s-style authoritarian regime to one of the Eurozone member states. A future and sudden rise of extremist parties—Golden Dawn in Greece and Marine Le Pen's Front National in France come to mind—could force those countries to withdraw from the Eurozone or the EU altogether. A significant anti-democratic turn by a non-euro member state, like Hungary, is also not unthinkable, and would have a profound impact on the future of the EU. Meanwhile, even further out in the tail, the Middle East may blow up and start a nuclear arms race if Iran gets an atomic bomb. Putin's Russia may invade the Baltics (which are all three euro members) under the ruse of "protecting Russian minorities," and the American economic recovery may falter, triggered by a new financial meltdown, impacting the economies of China, India, and Brazil, and ultimately the northern European export machine. However, if the deflationary trends in the eurozone itself continue beyond 2014, we may not need such exotic birds to do the damage at all. Existing policy continuing on autopilot may be all that is required.

What Does All This Mean for the Future of the Euro?

Such events could have huge consequences, or they may never come to pass. A seemingly minor white swan may cause serious damage to the currency's long-term future. Black swans may never take flight or, at the risk of stretching the metaphor, a whole flock may settle over Europe. We simply do not know. But what we can say on the basis of this book is the following:

- Without developing a political process to legitimately embed its economic and financial institutions, the future of the euro will be fragile at best.
- We know which institutions need to be built in finance, governance, and politics to make it work. They are detailed in the first section of the book. What Europe has built to date falls far short of these minima.
- There are no sustainable technocratic solutions to the euro problem, which is an inherently political one, and will need political solutions. Democracy is not a mere error term in the non-linear regression of governance.
- The major current risks to the euro stem from the attempt to make national-level austerity and structural reform superior objectives to restoring Eurozone growth and championing EU political reform.
- The future of the euro will be decided in Germany, Spain, and Italy. France has lost its leadership position in Europe, and has yet to find a role.
- The timing of politics outside Germany will eventually dominate the timing of German politics and the future of the euro.
- The Eurozone will gradually take over the EU in institutional importance, which will have significant consequences for the "euro-outs" like the UK,

Sweden, and Denmark. The outs may at some point face a painful choice between joining the euro and leaving the European Union altogether.

- The euro's international position may help it at the margin, but it is European domestic politics that will determine its future in the end.

What we know for sure is that the Eurozone, assuming we still have a euro a decade from now, which is far from certain, will look very different from how it looks today. More countries will likely have joined by 2025, including Denmark, Poland, and possibly Hungary, while some other countries, like Greece, Cyprus, and Portugal, may well have opted to leave. Some of the missing unions—maybe common deposit insurance or some version of a Eurobond—may have been introduced, with others still lagging far behind or remaining politically unthinkable. The global economy will continue to develop, and the individual national varieties of capitalism that constitute the European economy will continue to evolve in divergent as well as convergent ways.[43] Germany may well be struggling by 2025, while France could see an economic revival—it has happened before—and its demographics are much better. Britain may have left the European Union altogether. Belgium may no longer exist.

In closing, we are reminded of the observation made by the Greek philosopher Heraclitus (535–475 BC) that "no man ever steps into the same river twice, for it is not the same river and he is not the same man." Like Heraclitus's river, the Eurozone is a dynamic system that continues to advance and flow. The men and women in Europe's corridors of power also change, as does the nature of Europe's democracies and peoples' expectations of their national governments and of the European Union. As the next

generation of leaders takes office, they will likely have very different ideas from those of Kohl, Mitterrand, and Delors, or Merkel, Hollande, and Barroso.

Heraclitus tells us that the man was different the second time around, precisely because he had already waded into the river once before. The experience of the euro crisis should therefore have taught current and future leaders to put the euro on a more solid footing. In order to do so, all we can hope is that Europe's future leaders will approach the question of the single currency by beginning with the political foundations of markets. We dare even dream that they may have internalized the main lesson of this book, that a common currency is not a technocratic endeavor but a political choice: it needs to be fully embedded in democratic institutions to keep earning its legitimacy every day. The economist Abba Lerner, who we cited at the beginning of Chapter 1, once observed that economic transactions constitute "solved political problems." The euro is not there yet: Europe still has a long way to travel in order to solve its single currency's intrinsically *political* flaws. Only then will the Eurozone be able to fundamentally resolve its *economic* ones.

Notes

[1] Quoted in Rachman 2008.

[2] See, for example, Bergsten and Kirkegaard 2012; *The Independent* 2013; Talbott 2014; Chambers 2014; and also Jones 2014.

[3] See European Commission 2013b.

[4] See Taylor and Emmott 2014.

[5] See Chapter 2 in this volume.

[6] Henning and Kessler 2012, p. 7.

[7] Henning and Kessler 2012, p. 9.

[8] Henning and Kessler 2012, pp. 10–14.

[9] The single resolution mechanism, designed to resolve those banks if they get into (more) trouble, still has years to go before it can be fully operational and effective.

[10] International Monetary Fund 2014. *World Economic Outlook Database*. Washington, DC. Authors' calculations. <AU: Do you wish to add this source to References? MM: YES. I have added it.>

[11] On the decline of the western world and the rise of the rest, see Matthijs 2012a.

[12] See Chapter 10 in this volume.

[13] See Helleiner and Kirshner 2014.

[14] Interview with Romano Prodi at Brown University (Providence, RI), spring 2011.

[15] As Dustmann et al. point out, however, this is a case of confusing causation and correlation. See Dustmann et al. 2014.

[16] Interview with Romano Prodi at Brown University (Providence, RI), spring 2011.

[17] International Monetary Fund. 2013. *World Economic Outlook Database*. Washington, DC. Available at: http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx. Authors' calculations.

[18] Matthijs 2014b.

[19] Merkel 2010b.

[20] Van Rompuy 2012; Van Rompuy et al. 2012.

[21] European Commission 2012b.

[22] It remains unclear why the Commission felt the need to have its own report on the future of the Eurozone, which resembles the "Four Presidents' Report" so closely. The most likely reason is for the Commission to try to win back the legislative initiative after most of the institutional innovations during the euro crisis came from the Council, which includes only Europe's heads of state and government.

[23] Enderlein et al. 2012.

[24] Glienicker Group 2013; Eiffel Group 2014; and Legrain 2014.

[25] Glienicker Group 2013.

[26] Glienicker Group 2013.

[27] Eiffel Group 2014.

[28] Eiffel Group 2014.

[29] Legrain 2014.

[30] Legrain 2014, p. 10.

[31] Legrain 2014, p. 39.

[32] Taleb 2007.

[33] This part of the chapter borrows from, extends, and builds on Blyth 2009 and Matthijs 2012b.

[34] Black swan examples are the terrorist attacks of 9/11, the popular uprisings of the Arab Spring, or the London riots of August 2011. Also, note that all three types of "swans" can be positive as well as negative. However, given that it is frequency times impact that matters, negative swans tend to matter much more than positive ones for future outcomes.

[35] A fuller version of this argument is developed in Blyth 2014b.

[36] See Lawton 2013.

[37] Blyth 2013b.

[38] The EU Treaty on Stability, Coordination and Governance is available online at:

http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf

[39] Treaty on Stability, Coordination and Governance, Article 3.1(a).

[40] Treaty on Stability, Coordination and Governance, page 5.

[41] Treaty on Stability, Coordination and Governance, Article 3.1(e).

[42] For more information on the 'Six-Pack,' see European Commission 2012a.

[43] Hall 2014; and Hall and Soskice, eds., 2001.