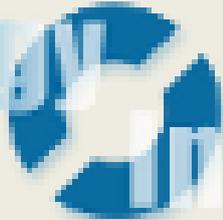


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“The Political Economy of Europe’s Debt
Crisis: Internal & External Implications”



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“Η Πολιτική Οικονομία της Ευρωπαϊκής Κρίσης Χρέους: Εσωτερικές και Εξωτερικές Επιπτώσεις”.

Συγγραφέας/Author: Δρ. Σωτήρης Σέρβος/ Dr. Sotiris Serbos

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The Political Economy of Europe's Debt Crisis: Internal & External Implications by Dr. Sotiris Serbos*

Introduction:

During the 21st century, Europe's environment has become more complex compared to past decades. The enlarged EU-27 is characterized by increased diversity. Enlargement has created a conflict between the complexity of the process and the disproportionately loose political framework at EU level to see this task through in an efficient manner. The insufficient level of integration amongst existing members places also emphasis on its political, social and cultural aspects and not simply the economic. The second related issue is the pre-existing democratic deficit in the decision making process in Brussels that has been the other major source of opposition to the EU's Constitutional Treaty. The way this issue relates to the enlargement process stems from the implication that the latter would impose additional difficulties for the creation of a European society of citizens and finally a common European political culture that all together might be taken to constitute operational pre-requisites for the convergence of the complex socio-economic and political processes that are in store.

In light of the above, Europe's common historical past has been coloured with different political, social and economic courses leading to development, including differentiated - as the case may be- European preferences and relevant strategies. In such a geography, where the traditional 'balance of power' approach has shifted, the difficulties encountered for searching common grounds on co-administrating European integration's vested interests, have worryingly increased. Regarding social perceptions, Europe's approach through individual or even collective citizens' subconscious –with the emphasis placed on younger generations- is by no means associated with post-war realities and the Cold War era. In addition, the unquestioned fact that the fluidity of the on-going economic crisis introduces elements of geopolitical uncertainty further indicates the necessity for adopting revised policies between the power centers of a diverging multipolar world.

Enter Europe:

For Europe, the key issue is how to manage suffering part of its global power. Turning from G-8 to G-20 and with Asia serving as the world's economic center, larger capital inflows will come from developing countries to Europe rather than the other way

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around. For the EU, it is of utmost importance to resolve the issue of highly indebted countries, a product of Europe's incomplete currency zone which allowed severe macroeconomic imbalances between its member-states and consequent divisions over creditor and debtor economies (instead of indebted state entities/citizens). In the policy-making arena, decisions taken will define its ability to act at the international stage. Inside the EU its dynamic is shrinking. It is actually shrinking towards Germany which holds the upper hand in the Franco-German axis, while re-positioning itself in the struggle of maintaining core national interests before moving to the next step of 'Europe's journey'.

Pooling sovereignty and establishing common rule-based responses build up mutual defences against common threats while spreading the benefits of stability and prosperity. In this respect, a balanced political consensus across Europe has to come forward, before a more serious deepening of the current crisis evolves or policy instruments run out. On the other hand, the issue of more Europe through greater integration is too large a project to be undertaken without broader public and social consent. This is especially the case for the political systems of EU's creditor countries, which have traditionally incorporated social consensus throughout the decision-making process. Achieving social consensus to rescue the Eurozone, conflicts with Europe's inherent democratic deficit. The latter fully unveils itself in the case of elites' struggle to rescue the banking system while at the same time avoiding delivering a message of truth to their citizens; the striking reality that EU creditor-debtor economies are partners-in-debt by courtesy of European banks.

Democratic legitimacy is being challenged today. Albeit with differences among European countries, there is a considerable lack of connection between political institutions and their social environment with both being affected. Not only does insufficient legitimacy diminish the capacity of democratic institutions to shape widely acceptable policies and to implement them effectively, it also weakens the integrity and functioning of society, which depends on democratic institutions as the central mechanism to accommodate social pluralism. Therefore, it should be beyond doubt that democracies in Europe have one clear imperative at present: to strengthen their anchoring and legitimacy in society. Only if we embrace society more broadly, will society be able to exert control over its elites, political and otherwise, and to withstand the less than democratic temptations occasionally invoked by populists and demagogues. Political participation does not come cheap anymore; it has to be won in the context of a real offer to share power. It is time this happened. In political science, we use to mention that "democracy doesn't work until there is a crisis". Well, there is a crisis, and this time democracy must work.

The issue of European policy coordination is a difficult equation to be resolved in a short period of time. For more than a decade, strong vested interests that shape current

economic growth models have been developed within both debtor and creditor countries. Germany places itself with neither the political willingness nor the economic and financial capabilities to adopt the leading role, towards recovery and sovereign debt management at EU level. Instead, it prefers the one of a free rider (continue with its policy of surpluses and through them offering aid to bail-out Europe's South and avoid their default). The unfinished business is put on hold until an agreement has been reached on how the burden will be shared between creditor and debtor economies, while all together bail out the European banks.

The strategy of "divide and rule" by Germany, is illustrated in the case of Greece, where the country is a recognized as a special case and the measures imposed set the benchmark for the other countries coming up. It was too late, when a few weeks ago; the Italian Prime Minister Mario Monti talked about the necessity of not excluding Greece from the rest of Eurozone's member-states. A debtors' alliance should have been established from the first place, so as to smooth recession and force creditors to quickly adapt measures at the European level, leading to a more diverse and expanded burden sharing. With the present situation, the common denominator will be the one that serves a direction where both Germany and the EU will meet in an efficient manner. Germany will push forward the unfinished construction of the European project so as to address EU's institutional shortcomings and guarantee its structural pitfalls, only through policy paths more compatible with its national interests.

Essentially, internal frictions among debtors and creditors in the EU will remain for years to come. For the time being, creditors are the powerful actors while debtors possess minimal negotiating power. This reality will probably result in decisions taken at the lowest common denominator when it comes to growth; indicating European financial discipline via German leadership and further integration to avoid destabilizing forces that will deconstruct the EMU and probably the EU as a whole. Creditors will agree to respectable low growth for a decade and push debtors to adopt restrictive policies. These countries will keep on saving so that they can repay their debt to creditors at real rather than inflated values. Although these policies present a variety of internal contradictions, this is how the bargaining works.

That being said, since mature European economies enjoy an advanced level of development, there isn't much space for further reform (unlike Greece). At the same time, to overcome European countries' internal debt (both public and private) sufficient economic development is required.

Which are the two areas to accomplish the goal of development? Policy planning in the long run will focus on: a) pension reform and b) a flexible labor market.

When it comes to population dynamics EU countries are dominated by ageing populations and projections point towards serious demographic deterioration. A posing problem which decreases the economy's potential for development. Essentially, Europe's potential development rate for the next decade will decrease from 1.7% to 1.3% respectively. A reality which can be counteracted through targeted migration policies (a policy already introduced in the case of Germany). Europe will need a flexible labor market to deal with ageing population. In addition, the issue of migration is linked with pension reform (raising the retirement age and adding social security contributions/otherwise countries' debt –both internal and external- will reach 200% of their GDP). In this respect, what counts is the quality of migration. Targeted (migration) means attracting young, matching and skilled population, which will provide vital

contributions for the economy's needs. By no means should we undermine the necessity for pursuing proper policies for their integration (one of the areas where the US outrivals Europe).

Furthermore, reform of labor along with a more lean health system, will additionally include the provision of incentives for increasing population's participation, as part of a growing labor force (i.e. more housewives to be included in the labor force, post-pension work etc.), along with the potential implementation of policies that will be granting financial incentives –apart from tax exemption- to increase birthrates (like in case of France and the Scandinavian countries).

In the meantime, if the South cannot escape from the vicious circle of debt through development (simply because there is not enough national income growth and the ratio of debt to GDP cannot decline); it will be extremely difficult for these countries to stand in the Eurozone or the EU. In this scenario, security issues will become essential and the path to protectionist policies will be more than open (inevitably the Single European Market will collapse).

If the EU is trapped in development rates like Japan in the past, Europe will face low economic development and poverty (the CEECs will not be in a position to enter the EMU, developing countries will also be affected –including the US- and a protectionist rally will begin in countries outside of Europe). Namely, a major economic and security concern for Eurasia. The US will miss a powerful ally since Europe will turn into a weak link with no single EU presence. Since the Americans cannot act by themselves in Eurasia, they will have to reevaluate their role and search for new allies that will secure transatlantic synergies for a wiser and more open global governance, or experimenting with isolationist trends.

In this respect, developing countries must prepare themselves and work in a responsible and constructive manner (BRICS, tiger economies, Turkey) in the international security system. Indicative examples of irresponsible policies include Turkey's migration policy vis-à-vis Greece, or China's position in international economy where it pursues command economy tactics to sustain its competitiveness. Furthermore, the US will continue suffering from high external debt, a development that will lead to restrictive policies for many years. In other words, Washington will be compelled to follow cooperative policies through constructive engagement and granting power in the developing world. In effect, the West (US and Europe) will be the actor establishing principles and setting limits on how to properly manage their growing power and assist them accordingly. Western societies should be sufficiently educated in order to properly adjust themselves.

A note from the past – A question for the future:

A key reason why many countries fail to join the globalization process is that the latter requires active citizen democratic participation and it can't be an affair of an enlightened elite, even in the rare case where there is one. This is a vital difference from the pre-globalization era where an elite was actually able to achieve great strides in economic progress via mixed economy planning and sound macroeconomic policies e.g. Asian Tigers. Even the extremes of the centrally planned economies were often admired by

western analysts for their success towards fast industrialization. In fact, it is countries that have excessively relied on elites at the expense of civil society evolution that are currently finding it harder to adjust as they lack the culture and often the democratic spirit that constitute prerequisites for innovation and creative flexibility at both leadership and grass root levels. Such conjunctures constitute a global risk as they lead towards vicious rather than virtuous cycles in economic development; because the inability to provide social safety nets perpetuates corruption, disincentives for work, demoralization of the workforce and international isolation.

In contemporary Europe, the issue of citizens' democratic participation is further exacerbated in the realm of national versus European identity. The present crisis has shown that there is a great deficit in this area. A clear indication in terms of political behaviour can be derived from the average German's perceptions or misperceptions towards highly indebted countries. As a result of democratic deficit, European leaders haven't set the problems as they should. Democratic deficit means failure to take responsibility for committed actions on behalf of political and economic elites. German citizens do not accept to be partners-in-debt, simply because nobody told them so. In this polarized and fragmented environment, European leaders' future consensus over much needed vital reforms in the Lisbon Treaty will face increased pressures from their domestic front. A quite delicate process which, at present, includes parliamentary ratification or even national referenda, i.e. political processes that can potentially block European elites' desire to complete the EU's unfinished construction.

Summing up, the EU will either have to implement long run policies (pension reform, flexible labor market) or to choose default. In terms of EU domestic politics, it is of paramount importance how different approaches between member-states, societies and electorates will run down. Unfortunately, long delays were needed for the Germans to understand the current situation. What is more important however, is the issue of democracy in Southern countries; at present high-stakes are being underestimated: If countries like Spain, Italy, Portugal, even the UK are trapped in low growth (the Greek case is not applicable since Greece suffers from a high spender public sector, so the issue of democracy is out of the question¹), reactions will come forward and a posing

¹ Greece is the only European economy with low private but excessive public debt. On the political front, the power structure in Greece is more reminiscent of the pre-globalization era with vested political/economic interests, feeding off public procurement, the sharing of subsidies linked to EU structural funds, a legacy of political clientism, the vague rules of the game regarding competition in the presence of a highly oligopolistic market structure. Public sector inefficiency and populism have ballooned foreign borrowing to unsustainable levels. In light of the above, citizens are accomplices since they are the ones electing governments and the Greek electorate is to be held responsible for a complacent political system. More than ever before, in the case of Greece's political system which is growingly unveiling deep-rooted symptoms of institutional inertia and cultural paralysis, major reforms are needed regarding

democratic problem will have to be addressed. Namely, for how long will the citizens and peoples of Europe continue to offer their consent to bail out the bankers? Last but not least, when it comes to the economy, expectations are the ones shaping the environment. If the policy shift doesn't flourish their governments will opt to default. They will escape from Germany but they will pull together all the others.

Conclusion:

Decisions taken at EU level regarding the Union's future direction will depend on how the different approaches to European integration between member-states will play out. The question is whether the globalization process, with its requirements for fast modernization and consequences for income redistribution, has rendered the overriding European goal for economic and monetary union insufficient, by raising the risks for the EU being turned simply into a common market that could face disintegration risks from the contradictory forces of globalization in the future. If that is the case, then the broader aspects of political and social integration and the need to exert stronger global influence in the cultural and external policy arenas are likely to gain in significance.

In principle, the Europeans are distinguished partners in making diversity the servant and not the master of their destiny. Strategic calculations which allow room for a rational approach point out that for Europe, more than ever before, a clear vision of the purpose is by all means needed. As with individuals or corporate bodies, self-definition is achieved through action. Who you are is symbiotic with what you do. Since choices express values, the political choices that Europeans will make in the next couple of years will define Europe's purpose and identity.

Drawing a conclusion, European integration is no longer just about peace in Europe. It is also about enabling the EU to assert itself in the era of globalization, with the Union's pendulum still swinging in search of a positive 'balance of power' among both its institutions and its member-states. An inward looking and uncertain Europe, mistrusted by its citizens, cannot hope to undertake this role.

issues of participation, with the aim of examining novel institutional paths to bridge the growing gap between society and "closed/semi-closed" oligarchic systems that have been embedded.