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The State of the Euro: The Worst may be Over but no End to the Crisis in Sight because of the Policies, the Politics *and* the Processes

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Calm has descended on the Eurozone, at least in comparison to the roller coaster ride of 2010 to 2012. But the crisis is by no means over. The policies, the politics, and the processes all pose problems. The economic policies focused on austerity and structural reform have not worked, judging by the low rates of growth of the Euro area as a whole and by the poor performance of many Eurozone economies, in particular in the periphery. The politics, as a result, have also been worsening. The spike in votes for the parties on the extremes of the right and (to a lesser extent) the left, combined with European citizens' growing disaffection and Euroskepticism, are matters of serious concern, and have been made all the more evident by the results of the European Parliamentary elections of late May 2014. Moreover, the Eurozone governance processes that have generated the problematic policies and politics have also unbalanced the long-standing 'democratic settlement' among EU institutions, by replacing the 'Community Method' with decision-making that has become increasing intergovernmental via the European Council and supranational via the ECB and the Commission.

In consequence of the policies, politics, and processes, the democratic legitimacy of Eurozone governance has come into question. Using the terms of political analysts, the problems for legitimacy stem not only from the weak 'output' economic performance related to Eurozone policies and the increasingly volatile 'input' politics of European citizens but also from the poor 'throughput' quality of the policymaking processes.[1] Eurozone policymaking

[1] *On output and input, see Scharpf 1999, 2012; on throughput, see Schmidt 2013a.*

has since the crisis been mainly characterized by 'governing by the rules and ruling by the numbers,'[2] as EU institutional actors have accompanied the (rather minimal) increase in joint liability through bailouts and loan guarantee mechanisms with an increasing tightening of the 'stability' rules, an increasing restrictiveness of the numerical targets, and an increase in the potential sanctions and penalties.

That said, as the crisis has continued, EU institutional actors have themselves sought to reform their throughput processes by slowly and incrementally reinterpreting the rules in an effort to improve policy output and to be more responsive to input politics. The ECB has moved very far from its very narrow, 'one size fits none' (inflation-targeting) interpretation of what it could do under its Charter; the Council, from the initial 'one size fits one' (read German) resistance to any form of shared liability or deeper integration; the Commission, from its strict adherence to the 'one size fits all' numerical targets; and even the EP, from its marginalized position of almost 'no size at all.' And yet, in their discourse to the public or even to one another, EU institutional actors have for the most part been denying that what they have been doing in any way bends, stretches, let alone breaks the established rules.

This leaves us with the following question: Is this kind of slow and incremental shift in throughput processes enough, in particular when contested, to enable the Eurozone to produce good enough output policy performance to enable it to emerge from the crisis sooner rather than later? And how does this affect the questions of legitimacy related to the increasingly volatile input politics?

A Crisis without End because of Failed 'Output' Policy Performance?

The worst of the fast-burning market pressures and panicked EU responses are certainly behind us. There are no more headlines blaring that a break-up of the Euro is imminent. This is not only because the crisis in the Ukraine has pushed the Euro crisis off the front pages but also because the Eurozone has stabilized. Major progress has even been made in solving one of the central problems for Eurozone governance, with the establishment of a Banking Union and a Banking Resolution Facility. Moreover, some countries that had been under IMF-EU Troika surveillance have exited or are close to

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[2] *See Schmidt n/a.*

exiting their conditionality programs, notably Ireland and Portugal, while some Central and Eastern European countries (CEECs) under IMF/EU conditionality since 2008 have also been cited for their success, as in the case of Latvia. Finally, most countries have moved out of recession, although growth remains anemic.

But despite this seeming recovery, the Eurozone remains fragile. The markets are quiet for now, but they could still panic were Italian economic prospects to deteriorate, Spanish banks to get into trouble again, or the results of the ECB's stress tests (i.e., its Asset Quality Review) to prove problematic for some big banks, or not credible overall. Moreover, while the Banking Union and Banking Resolution Facility provide the ECB with the necessary regulatory power, the ECB still lacks the financial firepower to rescue any really big banks, which remain too big to fail. And although the ECB's LTROs (short-term low interest loans) have indeed been a boon for the banks, they have not solved problems regarding restricted lending to the private sector, since the banks have had a tendency to buy up their governments' debt instead. As a result, small and medium-sized businesses, especially in countries in the periphery, remain starved for investment funds or even lines of credit, as banks have cut back on lending. This has led to bankruptcies even for economically competitive firms.

The problems remain especially acute for countries still in fear of the markets and/or under pressure from the Commission with regard to 'excessive' macroeconomic imbalances or deficits—which now includes France in addition to the many countries in the periphery. Austerity policies that demand rapid deficit reduction through cuts in public spending—which have particularly affected areas crucial for growth, such as education and training, or for sustaining consumption, such as pensions and public employment—have produced economic contraction, especially in the absence of other sources of investment, whether from the EU or the private sector. And 'structural reforms,' which seem for the Commission to have meant mainly increasing labor market 'flexibility' by reducing workers' job security along with their wages are naturally much more difficult to negotiate in such a climate—in particular in light of unemployment rates that remain all too high, and youth unemployment even higher.

Critics had warned about the problems with regard to the Eurozone's responses to the crisis almost from the very outset. The problems began with economic policies focused on financial stability, since the insistence that all countries tighten their belts while becoming 'competitive like Germany' through export-led, surplus-producing growth violated Keynes' 'fallacy of composition' (i.e., what works for one country won't necessarily work for all).[3] These policies also failed to deal appropriately with the interdependence of EU economies, in which surplus countries beget deficit countries. Notably, even when EU actors acknowledged the issue, they underplayed its importance by setting numbers-based rules that penalized deficits above 3% but only problematized surpluses above 6%.

Such policies have also had deleterious effects on matters related to social justice and human rights. Unemployment in the Euro area remains very high, at 11.6% in May 2014, although down from its record of 12.2 percent in February 2013. But many countries continue to have much higher rates (e.g., topping 25 percent in Greece and Spain, with youth unemployment above 50%). Moreover, social solidarity has been in increasingly short supply, in particular because conditionality for program countries has for the most part led to across-the-board cuts in pensions, health care, and the social safety net. Close to a quarter of the EU population was at risk of poverty or social exclusion in 2012, while on average 10 percent of the population of the EU was severely materially deprived, with higher numbers in particular in Eastern Europe and in Greece.[4] Additionally, a Council of Europe report in late 2013 concluded that the austerity programs that had resulted in public social spending cuts, especially in countries under international bailout programs, had produced significant human rights violations. The report in particular condemned increasing homelessness in Southern Europe, Ireland, and the UK as well as failures to provide adequate safeguards to ensure access to the minimum essential levels of food in Southern Europe—as governments limited food subsidies—and even of water in the case of Ireland with the introduction of fees.

Critics have attributed these problematic policies to a host of mistakes involving the framing of the crisis and the diagnosis as well as the choice of remedies and the lack of deep solutions. The problems began with the flawed framing of the crisis as one of public profligacy, which generalized the narrative about Greece to all other countries in trouble, when the crisis was actually precipitated by private debt resulting from the massive overstretch of the banks, the increasing indebtedness of households, and the mispricing of sovereign risk by the markets.[5] This framing in turn led to a flawed diagnosis

[3] *See, e.g., Skidelsky 2013; Matthijs and Blyth 2011.*
[4] *Eurostat 2013.*
[5] *DeGrauwe and Ji 2012; Blyth 2013.*

of the problem as behavioral, because the crisis was seen as following from member-states' failure to follow the rules of the Stability and Growth Pact—whereas in fact member-states like Ireland, Portugal, Spain, and even Italy had been virtuous in this regard throughout the 2000s. The correct diagnosis is that the problem was structural, because the ECB's inflation-targeting monetary policy produced increasing divergence rather than convergence between surplus and deficit countries.[6]

As a result of the framing and diagnosis, the chosen remedies have centered on pro-cyclical policies of 'sound' money, budgetary austerity, and 'structural reform' that exacerbated rather than solved the economic downturn. The Eurozone would have done better with counter-cyclical policies providing macroeconomic stimulus, industrial investment, and socioeconomic support.[7] But it would also have required deeper solutions to remedy the fact that the Eurozone has an incomplete risk pool and insurance mechanism put in place more by default than design.[8] Banking Union, which has finally been instituted, is only the beginning, rather than the end, of the initiatives needed to put the Eurozone on a sound footing. What the Eurozone would need to do is to complete monetary union with a financial union[9] or even a fiscal union through some form of debt mutualization (e.g., Eurobonds)[10] plus macroeconomic stabilizers (e.g., an unemployment fund or a 'cyclical adjustment fund').[11]

But for the moment, no such deeper integration seems possible. EU leaders continue to resist EU level solutions until they feel forced by the markets not only because of their reticence to support solutions that would involve greater shared liability and/or transfer of responsibility to EU level institutions—entailing ever greater loss of national sovereignty and control. They are also concerned about their citizens' reactions in light of the rise of anti-Euro and anti-EU feeling that has manifested itself in national politics, whether through elections, media discourse, social protests, and public debates.

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[6] *Enderlein et al. 2012, 2013; DeGrauwe and Ji 2013.*
[7] *Scharpf 2012; Jones 2013.*
[8] *Schelkle 2014*
[9] *Jones n/a.*
[10] *Claessens et al. 2012*
[11] *Enderlein et al., 2013*

An Economic Crisis that fuels a Political Crisis of 'Input' Legitimacy?

As it stands, the continued economic problems of the Eurozone, together with the social spillovers, have also negatively affected 'input' politics, meaning citizens' political attitudes and engagement. The results of the late May 2014 elections of the European Parliament, in which the politically extremist parties came in first in many countries, in particular on the right, is only the latest sign of how deleterious the economic crisis has been for EU and national level politics. As the output performance of Eurozone policies has worsened, input legitimacy has also been increasingly in question, as citizens' attitudes towards both their national governments and EU governance have declined dramatically, in lock step with their economies.

One of the problems for input legitimacy is that with the increasing primacy of EU level economic policies, national governments have often been caught between honoring their EU level commitments and responding to the wishes of their citizens. Most importantly, as Peter Mair argues, the EU in the midst of the Eurozone crisis has actually unsettled the balance between the two main functions of national level political parties in their relations with their constituents—representing citizens (input) and governing them responsibly (output). The crisis has forced parties to privilege responsibility over representation, by enhancing their governing role to the detriment of their responsiveness to national electorates.[12] Equally problematic is the fact that at election time opposition parties may very well be campaigning against the very policies that they will be expected to implement when they gain office, even against 'the will of the people.' As a result, 'responsible' (output) government increasingly trumps 'responsive' (input) government, even when the citizens consider the output detrimental.[13]

Citizens have in consequence been left with the sense that they have little recourse in the face of EU-generated policies of which they may disapprove, other than to punish national politicians. The fragmented nature of EU 'democracy,' in which policies are decided at the EU level but politics remains largely at the national level has meant that citizens tend to hold their national politicians accountable for EU policies[14]--in particular in the Eurozone crisis. The result has been the increasing cycling of incumbent governments,

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[12] *Mair and Thomassen 2010; Mair 2013.*
[13] *Mair 2013.*
[14] *This is what I have elsewhere described as 'policy without politics' at the EU level, 'politics without policy' at the national. See Schmidt 2006.*

as voters have punished their national politicians with growing frequency and intensity.[15] Such political volatility has become the rule not only in Greece, Spain, or Italy but also in the core, with France being a case in point—President Sarkozy was only the second president in the Fifth Republic not to have won a second term. President Hollande has the lowest popularity rating of any president of the Fifth Republic (17 percent in the latest poll in late spring 2014).

Increasing Euroskepticism or even anti-European—and not just anti-euro—feeling has been seen in all countries. Notably, this has been the case not only in the countries hardest hit by the crisis, in Southern and Eastern Europe, but also in those largely unaffected by the crisis economically, mainly in Northern Europe, as in the case of the True Finns in the 2011 elections in Finland.[16] Moreover, Euroskepticism has been growing not only on the extremes of the right and the left but also in the center. In a May 2012 Eurobarometer survey, among those saying that membership of the EU was a bad thing, respondents in the center outdistanced those on the left in France, Britain, and the Netherlands, and on both the left and the right in Finland.

Rising citizen disaffection from mainstream parties is also part of this, and can be seen in the growing electoral scores of parties not only on the extremes of the right and the left—as in Greece where the neo-nazi Golden Dawn polled 7 percent and the far left Syriza 23 percent in the June 2012 elections—but even what could be called the ‘radical’ center—as in Italy with the Beppe Grillo Five Stars phenomenon (with 25 percent of the vote) in the February 2013 election. This in turn makes for greater fragility for governments, with governing majorities on a knife’s edge, and greater difficulties for winning mainstream parties to form a government, as in the Italian elections of February 2013—although Italian Prime Minister Matteo Renzi’s historic win of 40 percent in the EP elections and Grillo’s underperformance relative to his predicted score suggests that Italy, at least for the moment, has managed to reverse the trend. But worse yet in terms of the rise of extremist parties is the possibility that anti-democratic governments will also emerge, as in Hungary.

Meanwhile, all the unions can do is agree to concessions while gaining nothing in return, as in the Spanish pension agreement and the Irish Croke Park deal, at the same time that the most social movements like the Spanish

[15] *Bosco and Verney 2012.*
[16] *Taggart, and Szczerbiak 2013; Usherwood, and Startin 2013.*

indignados manage to do is to mobilize members for protests and demonstrations that get them nothing other than, sometimes, news coverage.[17] Notably, the Council of Europe report in late 2013 condemned governments' side-stepping of regular channels of participation and social dialogue on the pretext of national financial emergency, as well as harsh responses against demonstrators and infringements of freedom of expression and peaceful assembly, as well as reductions in media freedom, in particular in public outlets, such as the closure of the Greek public broadcaster ERT.[18] Moreover, Eurobarometer polls demonstrate that in the years since the crisis began, citizens have demonstrated a massive loss of trust in national governments as well as a reduction in support for the EU (for national governments, a drop of 15 points between spring 2007 and spring 2012, down to 20 percent; for the EU in this same period, a drop of 26 points, down to 31 percent).[19]

Euro Governance Processes that also fuel a Crisis of 'Throughput' Legitimacy?

The challenges arising from the Eurozone crisis do not only involve issues related to the input responsiveness of EU institutional actors or the output performance of EU policies. They also relate to questions of 'throughput' legitimacy, which is a procedural criterion focused on the quality of the governance processes, involving considerations of efficacy, accountability, transparency, and accessibility.[20] That quality has come into increasing question as the policymaking processes have become more and more intergovernmental and supranational (or technocratic) in the course of the Eurozone crisis, leading Jürgen Habermas to warn against the dangers of 'executive federalism,' in which the tremendous shift of economic and budgetary power to the EU level has occurred without any concomitant increase in citizens' 'input.'[21] Moreover, the processes' focus on 'governing by the rules and ruling by the numbers' has been equally problematic.

Intergovernmentalism has replaced the 'Community Method'—in which Commission, Council, and European Parliament all contributed increasingly equally in their different ways to decision-making—as the main form of Eurozone decision-making. EU member-state leaders tend to dominate

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[17] Armingeon and Baccaro 2013
[18] Council of Europe 2013
[19] Eurobarometer, spring 2007, 2012
[20] Schmidt 2013
[21] Habermas 2011.

policy-making while treating the Commission largely as a secretariat, charged to help devise and then implement the stability-oriented, numbers-based rules. Of even greater concern is the fact that the Council has become dominated by ‘one size fits one’ rules of intergovernmental negotiation that have given one member-state (i.e., Germany) outsized influence to demand not just adherence but reinforcement of the rules, while the European Parliament has had almost ‘no size at all’ when it has come to setting policy, given the treaty-based rules of monetary governance.

At the same time, supranationalism has predominated in more technical domains, as the ECB has pressed the member-states to engage in austerity and structural reform in a *quid pro quo* for its own more vigorous monetary interventions, while the Commission has pushed member-state governments to meet the numerical targets of the stability rules through its enhanced budgetary oversight powers, or else face warnings and sanctions. The problems here also stem from the fact that at the inception of the crisis, the ECB did little to adjust its ‘one size fits none’ rules governing monetary policy, which exacerbated (rather than reduced) member-states’ economic divergences, while the Commission applied ‘one size fits all’ rules with a set of restrictive numerical criteria poorly adapted to member-states’ very different varieties of capitalism.[22]

With these ‘one-size’ rules-based governing processes, EU institutional actors seemed to have forgotten that democratic legitimacy demands not just rules to follow but politics that appeal to the citizens along with policies that work. It is in response to the output and input legitimacy problems that, as time has passed, all EU institutional actors have sought to reinterpret the throughput rules by which they operated at the beginning of the crisis. But they have generally done this without admitting that they have been bending and stretching if not possibly breaking the rules.

The incremental reinterpretation of the rules has arguably been most pronounced in the case of the ECB, which moved slowly from its ‘one size fits none’ throughput rules in which it denied that it could ever operate as a lender of last resort (LOLR) to a commitment to ‘whatever it takes’ (in the famous phrase of the ECB president in July 2012)—with a discourse that insisted that it remained fully within the remit of its Charter. Although the European Council has continued largely to govern via ‘one size fits one’ rules, Germany along with its coalitional allies have intermittently agreed to deeper

[22] *Schmidt n/a*

integration and beginning in 2012 to the need for growth (at least in the discourse) and most recently flexibility, while continuing to harp on the importance of stability. Despite the fact that the European Union Commission has continued to apply the restrictive 'one size fits all' rules and numbers that it was itself instrumental in devising, it has lately applied this with somewhat greater flexibility while continuing it harsh austerity discourse. Finally, even though the European Parliament (EP) continues to have almost 'no size at all'—it has sought to have greater impact through its increasing critiques of Council stability rules and Commission restrictive rule-following as well as through its successful push to have the appointment of Commission President linked to the winning party in the European Parliamentary elections.

This disconnect between what EU institutional actors say and what they do stems from the continuing divergences in member-state policy preferences and economic philosophies that, combined with the institutional obstacles to treaty change (in particular unanimity), make formally changing the rules near to impossible and even reinterpreting the rules contested. By informally reinterpreting the rules without admitting it, EU institutional actors have at least managed to create the space necessary to produce somewhat better output policy performance. However, in so doing, not only does the quality of Eurozone throughput processes suffer from sub-optimal rules that EU actors bend or break without much transparency let alone accountability. Their discourse also suggests to citizens that they are privileging responsibility over responsiveness, and thereby could exacerbate the problems of input politics even as they try to solve the output policy performance.

Finally, EU level throughput policymaking processes that emphasize intergovernmentalism and supranationalism, even if they were to have been successful in producing adequate output policy performance, are problematic for input responsiveness to the citizens. And they only further erode national democracy, even as they raise questions regarding the input legitimacy of EU level governance.

Conclusion

Considering the challenges to democratic legitimacy during the crisis of the Euro suggests that the EU needs 'output' policies that are more effective, 'input' politics that are more responsive to citizens, and 'throughput' processes that are more balanced and carried out with greater efficacy and accountability. The question for the EU is therefore not only whether it can get the economics right – by generating economic growth and social solidarity, not endless austerity and destructive structural reform. It is also whether it can get the politics right—by enabling citizens greater say over decision-making in ways that serve to rebuild trust while countering the rise of the extremes—and whether it will be able to develop processes that are less intergovernmental and technocratic, with less slavish attention to rigid numerical targets. For any of this to happen, much depends on how EU institutional actors respond to the continuing crisis, and whether they are able to incrementally alter the rules and numbers to promote better policy performance as well as to accommodate citizen concerns while opening up decision-making processes to greater EU and national parliamentary representation.

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