

The Failed Political Economy of the Euro Crisis

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The euro crisis has been extensively discussed in terms of economics, finance, political intrigues, and European institutions, but a key aspect—the political economy of the crisis—has received little attention. Politicians and social scientists from emerging economies, not least from Eastern Europe, look with amazement at this oversight.

Europeans need to absorb and apply the lessons of the substantial literature available on the topic of the political economy of crisis resolution. An excellent overview is the book, *The Political Economy of Policy Reform*, which my colleague John Williamson edited in 1994. He wrote a useful summary himself, and Jeffrey Sachs provided one of the sharpest contributions in his discussion of reform in Poland and Russia. This article focuses on how anti-crisis policy should be made, not on its content. It puts forward twelve principles for the resolution of an economic crisis.

First, policymakers must realize that a crisis has erupted and that it implies a radical departure from ordinary politics. In a serious crisis, the old economic system has to change fundamentally. But in the euro crisis, the French and German leaders refuse to acknowledge this elementary fact. Germans invoke their concept of *Ordnungspolitik*, meaning that everything has to be built slowly and organically, which is the opposite of crisis resolution. Yet the father of the German economic miracle, Ludwig Erhard, carried out currency reform and deregulation in one big package in 1948, which explains its success. The French habitually proclaim that “Europe does not do shock and awe,” with implicit reference to the Iraq war, thereby surrendering to the idea that Europe cannot solve a crisis.

Second, crisis resolution nearly always requires new leadership. Granted, changing new leadership throughout a continent with disparate and democratically elected governments is harder than in a single country plunged into turmoil. But the leaders who have taken an entire region into a crisis are not likely to be able to carry out the radical changes needed to salvage the nation and undo previous failed policies. The search for a new leader is often an iterative process. The greater the political instability, the faster an adequate leader can be found. The three eastern EU members with recent International Monetary Fund (IMF) programs—Hungary, Latvia, and Romania—all changed governments twice during their crises. After elections brought them new governments, the economies in Ireland and Portugal are looking better. Europe is happy to see new governments finally emerging in Greece and Italy, and it is restlessly waiting for elections and likely government change in Spain. The change of guard at the European Central Bank (ECB) may also be positive. But President Nicolas Sarkozy of France and Chancellor Angela Merkel of Germany remain the dominant European leaders. Since they have assumed most powers, they are primarily responsible for the many failed attempts at resolution of the euro crisis. Failed leaders do not solve crises. Therefore, it is doubtful whether Europe can recover before France and Germany get new leaders.

Third, crisis resolution calls for new thinking and it requires new, clear principles. Ordinary politicians are usually good at horse trading and compromises, but for crisis resolution, the opposite—namely visionary leadership—is needed. Reform in Eastern Europe after

communism and in Latin America brought a new group of outsiders to the fore, most of them economists. Europe needs such leaders as well. Mario Draghi at the ECB, Lucas Papademos in Athens, and Mario Monti in Rome might make the cut, but Europe needs to go outside the circle of old politicians stuck in the failed political molds.

Fourth, crisis leaders must focus on key concerns and not get distracted on side issues, wasting policy focus and causing unnecessary strife. An outstanding example of an irrelevant issue is the current French-German campaign for a tax on financial transactions (the so-called Tobin tax, named after the economist James Tobin). Such a tax is probably ineffective and harmful, as the Swedish example from 1983–91 showed, but more importantly it would do nothing to resolve the financial crisis. Even now, key politicians appear to focus on increasing their power rather than on solving the crisis. A case in point is the German and French preoccupation with weakening the European Commission, although they are not preparing any sensible anti-crisis programs themselves.

Fifth, economics must be given primacy over law and constitutions, which was self-evident for reformers in emerging economies. This explains why economists and not lawyers have led successful crisis governments. This principle does not apply actions that are illegal or unconstitutional. Crises are times when laws and constitutions are changed to set up new institutions and reform the old ones. In particular many Germans have problems with absorbing this insight, taking institutions as given or even holy, notably their own Constitution, the Treaty on the European Union, and the mandate of the ECB. Even so, they have just added a fiscal responsibility requirement to their constitution. For crises to be resolved, legal, national, or cultural obstacles must be overcome. EU institutions need to be strengthened and adjusted to be made viable.

Sixth, a comprehensive program for crisis resolution and reform must be worked out as soon as possible after a new government has been formed. It must be consistent and credible. It should not be too large, but it should contain all essential policies. Typically, such a program should be presented within one month of the formation of a new government.

Seventh, no consensus is possible in a severe crisis. As Sachs has put it: “In deep crises, there simply is no consensus to build upon, only confusion, anxiety and a cacophony of conflicting opinions.” Serious reformers are always controversial. Since consensus is impossible, it is a waste of time to seek it. The vested interests of the old elites are nearly always the root of the problems. They will suffer from reforms, and they will not take their loss lying down but instead will deploy their media in opposition to reform. As Williamson observed, reformers need “the will and ability to appeal directly to the public and bypass vested interests.” Since the main problem is the old elite, democracy should not be seen as an obstacle but as the best means to beat them. Two parliamentary elections in Latvia during the crisis resolution have defeated the oligarchic parties that ruled that country for two decades.

Eighth, transparency is vital. Crises breed rumors and suspicion. The new government must encounter this problem with maximum openness and reach out to the public over the heads of the old elite. Therefore, the government program must be clear and readable. The new reform ministers need to go out to the public and the media and explain their policies over and over again.

Ninth, international support is crucial. The key international financial institution is the IMF. It has several vital properties. It is technocratic and the bearer of a limited number of key

principles for macroeconomic stability. It has a strong professional staff and well-tested procedures for the swift resolution of a financial crisis and for review of the process of healing. Moreover, the IMF can deliver a large amount of financing fast without any legislative decision.

Tenth, a crisis program must be sufficiently financed. Otherwise it is likely to fail. As former Treasury Secretary Lawrence Summers has written, “program announcements that are vague and try to purchase stability on the cheap are more likely to exacerbate problems than to resolve them.” That is true of all the European Union’s five “comprehensive” crisis programs to date. Its ultimate mistake was to resort to financial engineering with dubious leverage without credibility, as it did in late October. Such measures do not arouse trust but distrust. Tragically, the current European leaders seem to lack an ability to learn from their repeated mistakes, and their populations are not wise or vigorous enough to throw them out.

Eleventh, the anti-crisis program must be implemented early and decisively, when a new government enjoys a honeymoon or what the former central bank chairman of Poland, Leszek Balcerowicz, has called a short period of “extraordinary politics” when the public accepts exceptionally radical reforms. It is better to be fast than perfect but late. The measures should be as front-loaded as possible. When the three Baltic countries launched their crisis programs, they carried out fiscal adjustments of 9 to 10 percent of GDP in early 2009, and virtually all indicators bottomed out during the first half of 2009. While Latvia carried out 60 percent of its needed adjustment in the first year, Greece did less than 30 percent and seems condemned to many years of declining output. The front-loaded Baltic anti-crisis programs encountered minimal social resistance, whereas the slow, delayed, and insufficient Greek measures unleashed massive protests. Early and decisive action makes economies hit the bottom early on and breed confidence and credibility. To quote Summers: “Where policy has succeeded...it has been based on clear actions exceeding the minimum necessary to stabilize the situation.”

Finally, successful, early fiscal reforms have several qualitative hallmarks. Expenditure cuts must dominate over tax hikes because expenditures can be reduced much faster than revenues can be raised, and people do not appreciate tax hikes when they receive fewer public services and transfers. Characteristically, expenditure cuts comprised three-quarters of the radical fiscal adjustment of the Baltic countries in 2009. Large expenditure reductions have to be selective, which makes them drive structural reform, slashing red tape and facilitating growth. Austerity must be perceived as reasonably equitable. Excise taxes on luxury goods and property taxes are suitable levers on the rich, while higher progressive income taxes are not very effective since the very rich often are registered as living abroad. Public wage cuts should be greater for those with higher salaries, and social safety nets need to be maintained.

This is the received wisdom of the literature of political economy of crisis resolution. None of these insights is original, but the current European leaders have largely proven immune to these elementary observations. The euro crisis is an illustrative collection of mistakes of political economy. It even took the European leaders several months before they accepted professional advice from the IMF. Few rulers in the developing world are that daft. Several unsuccessful political leaders have fortunately departed, but the two key players, Sarkozy and Merkel, persist. Since they have assumed most power in the European Union during the crisis, the main responsibility for this astounding disaster falls on them. As Sachs has noted, “Europe hangs on the words of Chancellor Angela Merkel, which are sporadic and often doled out on the eve of eurozone summits.” After almost two years of crisis, neither Greece nor Italy has

any plausible anti-crisis programs. The latest Italian “austerity” budget without any cuts is nothing but a bad joke. And the European Union is about to run out of credible sources of financing after its many failed anti-crisis programs. This folly has apparently driven Europe into an unnecessary recession.

Given the miserable performance of the current set of political leaders, they have lost all credibility. There is little reason to believe that they will be able to resolve the crisis. This is not a moral or political statement, but an assessment based on rather elementary political economy. In the end, crisis resolution is a matter of restoring confidence in the state. For that task, Europe needs new leaders, who can handle a crisis in a relevant way. Until then, the euro crisis is likely to persist.

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