THE EU CRISIS AND THE WAY FORWARD: A VIEW FROM CYPRUS
An alternative proposal on the fiscal framework in the EU*

Andreas Theophanous
Professor of Political Economy and President of the Center for European and International Affairs of the University of Nicosia

Introduction

The objective of this policy paper is to evaluate the current debt crisis, which constitutes a much broader crisis for the EU and put forward some constructive suggestions. The first section briefly examines the background and context within which this discussion takes place. Section II puts forward some theoretical premises while in the final third section some suggestions in relation to the future of the Eurozone and of the EU are made.

I. Background and Context

The EU is facing its most serious economic crisis since the creation of the Common Market in the 1950s. The grand achievements that followed the completion of the Single Market, the Monetary Union and the Common Currency are under immediate threat. It is essential to understand the broader context of the crisis, including the debt crisis, unemployment and above all how to take the debate on the future of Europe forward. These issues and challenges constitute the toughest test for the ability of the EU to regain its standing and thereafter to refocus on its future.

The situation has resulted on the one hand in growing Euroscepticicm and, on the other, in forces calling for closing the solidarity deficit. So far given the constraints and the rules of the game, the EU has been trying to contain the repercussions of the crisis. Many would argue that much has been achieved though it is clear that much more remains to be done.

The overriding concern in the EU today – one that is shared globally as shown by the recent G8 summit – is the specific fiscal policy that is being followed in relation to the broader crisis in a number of Eurozone countries. The current policy approach is intensely disputed by different philosophical streams and schools of thought.

There are times when strict adherence to specific fiscal indicators creates more problems than it solves. By definition, fiscal consolidation and the rationalization of the revenue and expenditure sides of a state budget must be a sine-qua-non in any country. At the same time however, we should not disregard the significance of other relevant factors.

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In Greece today there is suffering not only as a result of a corrupt socio-economic and political system but also as a result of one-sided policy prescriptions imposed by the EU in the last two years. In this regard there appears to be an unprecedented adherence to the philosophy of draconian fiscal discipline without any effort to promote growth policies. When an economy is in recession and it has to suffer through additional taxation and expenditure cuts, economic activity is crippled, the standard of living drops and fiscal indicators deteriorate. Furthermore, when an economy is in crisis, a sustained policy of fiscal austerity leads to misery. Improved fiscal indicators can only emerge from a growth policy combined with a particular long-term and persistent policy of fiscal consolidation and rationalization of revenues and expenditures.

The EU must re-examine policy priorities and the results of the philosophy followed so far in relation to the Eurozone which has often run against the provisions of a fiscal union. It is a dangerous misconception to believe that the cost of a presumed exit of Greece from the Eurozone would be minimal as other countries may also leave the Eurozone if their economic conditions further deteriorate.

II. Theoretical Premises

Even long before the introduction of the euro it had been pointed out by several theoreticians that it would have been extremely difficult for the monetary union to deal successfully with a major crisis in the absence of a fiscal union. The Greek case became the focus of attention beyond Europe affecting the shaky global balances. There are several and often conflicting views in relation to this. One view argues that it was a mistake to allow Greece to enter the Eurozone as it had not satisfied the relevant criteria and points to the size of support the country received in fighting its debt problem. On the other hand, another view put forward is that the aid toward Greece was inadequate and, moreover, that the current prescription has been suffocating the country and deepening the crisis.

There is no doubt that Greece requires fiscal rationalization, prudence and discipline as well as a new revitalized economic structure. But given the depth of the crisis it also requires additional substantive assistance to stimulate growth. There is a limit to the austerity measures that may be adopted.

It seems that the EU so far views the Euro in the traditional definition of the currency: as a means of exchange, as a store of value and as a unit of account. The Anglo-American perspective is different than the one perceived by the EU so far: a currency is also seen as a flag. During the debate about the EMU in the 1990s the US economist Martin Feldstein had indicated that a single currency in Europe would make sense only within the framework of a federal union. He argued that in the absence of such a vision and clear political objectives the adoption of the euro would create more problems than benefits. Among other things, he predicted the persistence of unemployment and, given the existence of asymmetrical shocks and different circumstances in each country, the emergence of a new set of developments which could cause considerable strife at both the European and international level.

Nevertheless, the idea of the EMU and the euro were received positively by others. The adoption of a common currency made sense from an economic perspective irrespective of an *a priori* existence or not of political objectives. The existence of a single market which was moving more and more toward further integration in conjunction with the existence of different national currencies would always lead to situations of currency crises for a variety of reasons. Certainly, such outcomes could be counter-productive. Moreover, the adoption of a common currency could lead to price stability and harmonization, drastic reduction of transaction costs and would also contribute to the creation of a truly single integrated European market.

At the same time it should be stressed that the adoption of the euro created processes that could lead not only to further economic integration but also to the possibility of further political cooperation. The creation of the European Central Bank (ECB) and the introduction of the euro were thought of as potentially applying pressure to develop political mechanisms for holding monetary policymakers more accountable.

Monetary unions in the past can generally be distinguished between two categories: national and multinational unions. Their experiences provide us with a number of useful lessons. Most importantly, national and multinational monetary unions were set up with broadly the same economic objectives: to facilitate trade by reducing transactions costs of currency exchange, reduce or even eliminate trade restrictions, reduce exchange rate volatility and prevent wasteful competition for seigniorage. National monetary unions were set up for the added political imperative of creating nation states.

Unlike national monetary unions, multinational monetary unions of the past did not survive the test of time. Multinational monetary unions (such as the Scandinavian Monetary Union) could not survive in an unstable international environment and with pressures on divergent paths regarding the optimal mix of national fiscal and monetary policies.

National monetary unions (i.e. US, Germany, Italy) have endured despite considerable strains reflecting the cohesion of their underlying nation states. They also evolved into fiscal unions whereby considerable economic powers were transferred from the regional level to the national authority, either centralized or federal. Fiscal prudence and stability therefore emerge as necessary conditions for the viability of a monetary union.

The EMU is different from earlier experiences of monetary unification in several respects. Whereas multinational monetary unions in the past kept separate monetary authorities, the EMU has created a single currency and a common monetary authority. In contrast with national monetary unions, member states have kept a substantial part of their political sovereignty and also a large degree of fiscal sovereignty. A key potential problem is conflict among national agendas for growth and full employment. This problem of course is related to the incidence and severity of potential asymmetric shocks. It should, however, be considered that political will toward the creation of cooperative fiscal arrangements and greater political integration will be vital for the underlying durability of the EMU.

From a practical perspective the adoption of the euro involves a policy of fiscal restraint. In the long-run this leads to positive outcomes such as accountability in relation to how public funds are allocated and spent, pushing aside wasteful spending and thus promoting efficiency. But in the short run, fiscal restraint may cause hardship and the adjustment costs may be high.

III. Toward a New Approach – A View from Cyprus

The debt crisis and the overall economic crisis raise several issues including fiscal consolidation within and solidarity among the member states. But above all the EU may have to revisit some fundamental economic principles. Containing budget deficits and encouraging rationalization of public spending is in principle correct. But trying to maintain balanced budgets annually irrespective of the economic circumstances of a country would, most likely, create more problems than it could solve. Indeed during a recession such an approach is pro-cyclical; in other words, it worsens a recession. At times it may turn into a depression. The case of Greece may be indicative.

In Cyprus too, when unemployment is around 10% instead of following a growth oriented policy direction, the overriding objective appears to be locked on a tight fiscal policy. At this juncture, priority should be placed on growth. Additional budgetary spending cuts must be the result of measures aimed at fiscal consolidation and rationalization as well as the removal of distortions. Such measures would have to be implemented even if the fiscal balance had been in surplus. Additional taxation measures at this stage though will create more problems than they will solve.

The assumption of the EU Presidency by the Republic of Cyprus in July 2012 provides an excellent opportunity for the government to submit an alternative proposal in relation to the ongoing economic crisis. In short, and given the overriding concern regarding fiscal policy at the Pan-European level, it is important to put forth our own proposal for fiscal balance over a longer period of time instead of annually balanced budgets. It may be recalled that in the first post World War II years this was similar to the formal fiscal policy of Sweden (in this case the average over time was 0%) and it appeared in the literature as the Swedish Budget.

Such a context, would, for example, allow states to aim for a balanced budget on the basis of the average over an extended period of time (such as five years for instance). This would permit a discretionary expansionary fiscal policy in times of recession or crisis. This specific approach encourages a growth orientation. The specific details of this approach must be further explored by the appropriate policy units to be submitted to our European partners for discussion. Furthermore, it is of utmost importance to move forward with an enhanced fiscal union. That may also mean that spending of the EU will have to increase considerably from currently 1% to about 3% of the total GDP of the Union. The suggested approach will enable the Union to support particular countries when in need with targeted spending patterns. Understandably, for the implementation of this policy option it is essential to reach a consensus for closer integration. This in turn may entail greater solidarity but also greater commitment of countries to move forward with the necessary reforms for fiscal consolidation and a greater degree of integration.

Obviously the issues under consideration require a new paradigm. It is questionable whether in the long run there can be a monetary union without a fiscal union. Recent discussions for a Banking Union constitute a step in the right direction. Moreover, fiscal federalism can offset the effects of asymmetric shocks thus adding to the operation of a monetary union. The transfer of more fiscal responsibility from the national level to a would-be federal authority in the Eurozone seems to be necessary for the viability of the monetary union but one which is difficult to achieve. Some analysts go even further to claim that a common currency can only exist within the framework of a political union. These issues deserve to be addressed quickly and with an open mind.