The democracy **deficit**

*The eurozone is grappling with a fiscal crisis but **David Rowe** argues its ability to cope is being hampered by a democracy deficit*

"A spectre is haunting Europe – the spectre of communism" (Karl Marx, *The Communist Manifesto*).

Once again a spectre is haunting Europe. Not communism this time – which stands badly discredited by the millions of lives it has blighted or destroyed – but a democracy deficit that is hampering the continent's ability to address economic and fiscal imbalances that have been accumulating in the eurozone over the past 12 years.

In July 2005, I argued that "history will not be rushed" (*Risk* July 2005, page XX, *www.risk.net/1498376*). This was in response to the resounding 'double no' vote in France and the Netherlands on the proposed European Union (EU) constitution. A period of reflection followed in Europe, but far from accepting a more measured pace of integration, EU politicians rammed through the Treaty of Lisbon in late 2007. This contained many of the same changes as the rejected constitutional treaty, but was formulated to avoid the pesky necessity of popular approval in national referendums everywhere but Ireland.[1]

Despite some streamlining of its decision-making processes in the Treaty of Lisbon, the EU is not a political union and is viewed by many Europeans as a distant, unrepresentative and unresponsive source of regulations and constraints. It is this democracy deficit that lies at the heart of the current European crisis.

I have been a euro currency sceptic since the project began gathering steam in the 1990s – its success surprised me, but nagging doubts remained. Yoking such culturally disparate political entities as Germany and the Netherlands with Greece, Italy, Spain and Portugal in a common currency area was bound to be a structurally risky undertaking in the absence of accompanying political and fiscal union.

The 'no bail-out' pledges in the initial EU constitutional treaty were intended to concentrate the minds of politicians and the public in countries that had traditionally been unable to exercise sound fiscal discipline. With the traditional safety valve of currency devaluation having been removed, it was thought – or hoped – that these countries would change their ways. Sadly, the ability to borrow in a currency that markets expected to be defended by Bundesbank-style discipline resulted in lower interest rates and cheaper borrowing for all eurozone nations, with little stiffening of fiscal resolve where it had been lacking previously.

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It should also be said that Basel II's 0% risk weight on sovereign debt encouraged banks to hold those assets because there was no impact on regulatory capital – and modestly higher interest rates in southern European countries made their debt attractive relative to more disciplined countries.

After a surprisingly good run, the inherent contradictions of monetary union without fiscal union are emerging with a vengeance. Greece, and potentially Portugal, may be unable to stabilise their finances without formal default and restructuring. Even scarier is the possibility that the far larger problem of Italy may not be resolvable without restructuring.

The US economist Milton Friedman once compared currency devaluations to daylight saving time. It is much easier, he argued, to have everyone change their clocks than to leave the clocks alone and force everyone to get out of bed an hour earlier. It's a fair point: the alternative to devaluation is forcing nominal reductions in wages and prices, but wages are often fixed by legally binding bargaining agreements and cost pressures can inhibit price reductions.

Having entered voluntarily into a monetary union without fiscal and political union, many countries have continued their undisciplined budget deficits – a course encouraged by unrealistically small rate differentials among eurozone countries. But the party is finished, the hangover is very real, and the EU's democracy deficit raises doubts about its ability to put its house in order following the binge.

One last thought – Americans tend to think of this as a European problem. This ignores the impact that a serious crisis in Europe would have on US exports and earnings of US companies' European operations. We should also worry about the unknown net exposure of US banks to European banks and European sovereigns through the credit default swap market. This has the potential to trigger a freeze in the interbank lending market similar to September 2008, when no-one knew how much trouble any individual bank might be experiencing. ■

[1] *After an initial narrow rejection of the Treaty of Lisbon in June 2008, Ireland held a second referendum in 2009. By this time the global financial crisis was in full swing and the treaty was approved in this second vote by a margin of more than two to one*