Introduction

Winston Churchill – Zurich, 1946

"I am now going to say something that will astonish you. The first step in the re-creation of the European family must be a partnership between France and Germany. In this way only can France recover the moral and cultural leadership of Europe. There can be no revival of Europe without a spiritually great France and a spiritually great Germany. The structure of the United States of Europe will be such as to make the material strength of a single State less important. Small nations will count as much as large ones and gain their honour by a contribution to the common cause."

Schuman Declaration of 9 May, 1950

"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity. The coming together of the nations of Europe requires the elimination of the age-old opposition of France and Germany. Any action taken must in the first place concern these two countries."

Sixty years after Robert Schuman's declaration – almost to the day – Europe faced its greatest political test and its leaders decided to support one of its members financially on a massive scale. 2011 seems likely to pose even tougher tests and the results could mark a turning point in the political evolution of Europe. The eurozone may cement a more collective form of economic governance, while other countries such as the UK, move further into the margins.

Consider the New Year messages from three political leaders:

- President Sarkozy of France: "Do not believe, my dear compatriots, those who propose that we leave the euro. The isolation of France would be folly. The end of the euro would be the end of Europe. I will oppose with all my might any step back that ignores 60 years of European construction, which brought peace and brotherhood in our continent… Europe is essential to our future, our identity and our values."
- Chancellor Merkel of Germany: Europe has faced a big test in recent months. We have to strengthen the euro. It is not just about our money. The euro is much more than a currency. Fortunately, we Europeans are unified. A unified Europe is the guarantor for our peace and freedom. The euro forms the basis of our prosperity. Germany needs Europe and our common currency, for our own well-being and also in order to overcome big challenges worldwide."
- Prime Minister Cameron: His message did not mention the word 'Europe'.

The comments from the eurozone contain two elements: preserving the economic gains from European integration – maintaining the single market – and an external dimension of Europe's place on the world stage. In the financial sphere, the EU is already projecting its power via soft economic influence that comes from trade. But it also stems from exporting its legislative model around the world to any country that wants to modernise its financial legislation with single, modern measures such as IFRS, UCITS, MiFID, Solvency II, and the EU's influence on the G20 process, Basel etc.

However, the EU will soon have to re-shape some of its financial regulations to reflect the imminent victory in the real world of the 'bond market vigilantes' over the macro-econometricians who have ballooned public debts until their sustainability has been challenged. That may produce profound political change, even during 2011: a volcanic eruption is developing from which a loose political federation called 'Eurozone' may well crystallise.

Overview

The EU Fiscal Crisis: Forcing Eurozone Political Union in 2011?

This book examines the responses to the economic and fiscal crisis and the direction being taken towards European political integration. It looks at the development of the single market in 2010, regulatory issues in the EU and wider economic pressures. It analyses how and why the implications are for integration rather than disintegration. At the end of the crisis, Eurozone will have emerged as a political federation – loose in some respects, but with tightly centralised economic governance at its heart. The proven commitment to fiscal probity may even make it attractive relative to alternative investments around the world.

Part I covers the development of the single market in financial services in 2010 and the plans for 2011. It gives some specific examples of the continuing process of deepening the single market. There seems to be no visible intention to back-track on this – at least in the financial sphere. Indeed, the logic of the G20 process is to force more policy co-ordination at the global level and the simplest way for the European Union to deliver on these commitments to its global trading partners is to press forward with an even deeper single market.

So the wave of EU level regulatory activity is set to grow. These actions are Schuman's "concrete achievements" and they have certainly created a "de facto solidarity". Would they, or even could they, endure a massive shock to that solidarity in the form of a disorderly and rancorous break-up of EMU? The EU has already decided to drive this deepening forward just at a moment when the political strains from the financial crisis seem set to sharpen.

Topics covered in Part I include:

- The critical importance that, in the forthcoming legislative decisions to be made by Parliament and Council, the implications on the single market for financial services be given central consideration. The supervisory structures that have just come to life are likely to mark the EU's financial landscape for a long time.

  It would be a serious strategic mistake if the Council, under the pressure of Member States giving priority to a natural tendency to protect national supervisory competences, were to favour timid solutions. These would create the risk of a fragmented and more vulnerable single market.
- Any citizen who fears that his home state is about to leave the euro to implement a major devaluation can transfer their liquid funds into a bank in another eurozone state – in an instant and at negligible cost. In effect, this is a free option for all citizens and amounts to an instantaneous referendum on government policy. Such an outflow of retail liquidity from a banking system would cause its rapid collapse as even the new Basel III proposals on liquidity assume retail deposits to be particularly stable. The quiet run out of deposits in the Irish banks last year demonstrated the power of depositors to force radical political change.
- The perennial problem of 'more Europe or less Europe'. It may well be that the only way to achieve the objective of providing a high level of consumer protection with that of creating a genuine single market is 'full harmonisation' of some specific, targeted measures.

- 2011 will see a raft of detailed proposals that will pave the way to consumers becoming more accustomed to a genuinely single market in financial services. As time goes by, citizens will find that their everyday life is increasingly bound up with cross-border financial activity and the loss of the single currency would cause a major disruption to their life.
- A single set of accounting standards is an absolute necessity. Owners of a security must know what assets and income are backing it. So they must understand completely the accounting standards that define these financial variables.

  The power of the EU to create global influence for such standards may well be matched with equally dramatic internal implications during the next decade. In the current fiscal crisis, tax revenues are a vital resource for any state and a single set of accounting standards may promote tax harmonisation.
- The role of the EU in the G20 and reform of financial regulations: Implementing global agreements – in the EU context – will inevitably mean another step forward in the intensity of the single market through the creation of resolution regimes (i.e. dismembering large bankrupt banks without destroying the economy).

Part II covers integrating European economic governance, with crisis as the driver in 2010 providing a stronger structure in 2011. It provides context to the current crisis, in terms of the political and legislative responses, examining the timetable of recent events in the eurozone and their implications.

The chances of future fiscal crises should not be understated. The integration of a single financial market emerges as a critical factor: should the EU move towards 'more Europe or less' in this field? Former Commissioner Mario Monti has pointed out that the EU is already committed to far-reaching reform as part of the G20 process and "It would be a serious strategic mistake … to favour timid solutions."

At the very least, the Eurogroup must act together to change EU regulations to take proper account of the new reality they are imposing.

Topics covered in Part II include:

- When financial commentators talk glibly about the possible disintegration of the euro, they may not be thinking deeply about the full implications if such a process were accompanied by a fracturing of this carefully nurtured relationship between France and Germany. There is an alternative outcome to a fracturing: could the crisis instead lead to a deepening of the relationship that would run well beyond France and Germany and include all members of the eurozone?

  The Heads of Government announced "that they stand ready to do whatever is required to ensure the stability of the euro area as a whole. The euro is and will remain a central part of European integration."

  There is much media discussion about the opposite result – some countries leaving the euro. Anxious depositors would have plenty of time to remove their deposits from banks in any states that might leave. The natural and logical consequence of a collapse of all banks in those states may deter politicians from going down that route.
- The crisis as a eurozone issue: The driving force is the belated recognition by eurozone political leaders that the nature of their debts was fundamentally altered when they gave up the power to print money to repay such debts. Given the huge scale of public debts markets are now posing an even more fundamental question: will political

leaders countenance an even higher degree of solidarity than they agreed as recently as May? The solution to these questions is increasingly a eurozone rather than EU issue – a bifurcation that may well prove to be a turning point of historic significance.

So the eurozone, rather than the whole EU, should be responsible for dealing with all future ramifications of this crisis.

- The chances of a Treaty change being agreed and ratified within the timescale of a rapidly rising fiscal crisis are close to nil. Practical solutions to this crisis must be found within existing institutional arrangements. In the decades ahead, the eurozone may prove that its collective economic governance arrangements really do force its members to pursue fiscally sound policies, so adopting joint liabilities could well be non-controversial at that distant stage.

Finally, Part III examines the vital issue ofhow financial integration will force political integration of the eurozone in 2011 and later. It looks at the immediate state of government bond issuance, economic governance, the role of sanctions and of financial assistance.

Topics covered in Part III include:

- Policymakers must move back to first principles swiftly to ensure that no Member State can ever blackmail the Union again. The approach must be as rigorous and comprehensive as the reforming response to the private sector crisis because the Union has been proven beyond all reasonable doubt to have defective disciplining mechanisms. This is the challenge for 2011.
- The backdrop to a series of potentially difficult bond issues by risky states will be a string of rows among EU policymakers that may make market participants

wonder how serious the Member States really are about preventing any recurrence of this type of fiscal crisis. The Commission's autumn forecasts still point to rising debt burdens this year and next in the risky states – in some case quite sharply.

- The eurozone now faces several options for its future actions. Considering specific scenarios may be the best mechanism to illustrate the choices that must be made and each scenario simply lays out the developments that flow logically after each choice. Three scenarios are considered: an inflationary debt spiral; default; or the emergence of a collectively strong, federal eurozone.
- Once the Head of Government of the core states realise that their banks have lent 23% of their assets (€1.9 trillion) to the six states now deemed risky by the markets, they have little choice but to continue swiftly to cement rigorous fiscal consolidation and enhanced competitiveness. With that assured, the EFSF should be roughly quadrupled so that €1 trillion is capable of being disbursed to fund the risky states for say the next three years until the benefits of the restructuring are clear.
- A political federation called Eurozone with 330 million people will have emerged.