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Diskussionsbeiträge / Discussion Paper Series

No. 2015-06

Any Solution in Sight to Europe's Crisis? Some General Thoughts from a Conflict Theoretical Perspective

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August 2015

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To appear in:
T. Krieger / B. Neumärker / D. Panke (eds.):
Europe's Crisis: The Conflict-Theoretical Perspective
Nomos Verlag, Baden-Baden, 2015

I. Introduction

Over six years after its outbreak, Europe's crisis lingers on. The EU Member States still have not managed to work out how to return to a steady and sustainable growth path that helps to maximize welfare across the Community. While we have seen some steps towards a common response to the crisis, such as the introduction of the banking union and the European Stability Mechanism (ESM), it is undeniable that there are too few common, that is Europe-wide, measures to address this crisis with its truly European dimension.

What we instead see all too often are unspecific complaints that times are bad, that fellow Member States are behaving selfishly, and that reforms – while inevitable if the crisis is to be resolved – need to be postponed until after the crisis. The dispute between the new Syriza government in Greece and the Eurogroup (in particular its German representative) is the most striking example of a large number of unresolved inner-European conflicts. Generally, the Member States' response to the crisis has been disappointing. They have been, and still are, fighting the symptoms rather than the causes, while national interests remain the main drivers of policy measures, a situation that strongly calls into question the idea of European solidarity.

The crisis has revealed that Europe's institutions lack the framework required to deal with EU-internal conflict. This brief chapter sheds some light on Europe's organizational structure from a conflict theoretical perspective and outlines future requirements to be placed on Europe's institutions and its conflict-solving mechanisms.

II. The Origins and Progression of the Financial Crisis

The impact of the US subprime mortgage crisis in 2007-08 infected Europe, too, abruptly terminating the exceptional economic growth that Europe's periphery had enjoyed during the prior decade. International investors that had invested heavily in southern Europe and in Ireland suddenly realized that the convergence of interest rates in the Eurozone did not translate into a convergence in default risks across the Eurozone. The heavily concentrated and construction-dependent economies on Europe's periphery, with their oversized banking sectors and/or heavy public debt, were soon considered too risky and capital rapidly redirected to safe havens in northern Europe.

As a result, the countries on the margins of Europe came under pressure from several fronts. Their banks and construction companies collapsed, their economies shrank, and their unemployment rates skyrocketed. Their budgets groaned under the burden of the necessary bailout funds for the banking sector and increasing social spending. This development was especially severe because these countries had failed to implement structural reforms during the boom years after they entered the Eurozone.

The countries in the central Eurozone and particularly Germany that did implement structural reforms before the crisis benefited from the capital flowing back from the periphery. Although they, too, experienced some problems in the banking sector, they were reluctant to share liabilities with the peripheral countries. The countries at the core hoped to create immunity against the peripheral countries' debt and hence escape the crisis unscathed by rejecting Eurobonds, demanding a close link between liability and supervision, imposing the requirement to implement reforms *before* assistance, and demanding a stronger 'Maastricht Treaty 2.0'. At the same, these measures aimed at preventing future moral hazard by setting clear boundaries for unilateral government actions within a common currency area that lacks common economic and fiscal policies. However, a more careful analysis of the situation in Europe reveals the impossibility of this strategy.

For one, the assumption that the countries whose debt increased should be held individually liable is anything but straightforward. Although the European periphery was wrong to allow a set of wrongly developed incentives affect their economies and finances, international investors failed to recognize the risks. For too long, they fostered the problematic developments by sending enormous amounts of capital to the European periphery. Once the risks had become impossible to overlook, the investors started to withdraw most their capital and thus contributed heavily to the troubles these countries are currently experiencing.

For another, though commonly argued otherwise, the crisis has already spread to every economy in the Eurozone. Because of the tangled, opaque ties between securities at the beginning of the crisis, countries ring-fenced their banking systems before the effect of the crisis had become fully apparent. Other risky exposures, for which taxpayers were forced to assume liability, were pooled in bailouts and other structures. Almost every country in the EU suffered from a ratings downgrade and thus higher refinancing costs. The common monetary policy expanded, creating inflationary risks and asset bubble risks in core countries. Even if the crisis does not eventually cause the peripheral countries to default, the Eurozone countries will have assumed liability without taking into account the origins of the crisis.

III. A Conflict Theoretical Interpretation of Government Actions in the Current Crisis

Although the costs of the crisis have spread across Europe, the extent to which a country must carry the costs and risks is not predetermined and burden shifting is possible. The ultimate costs depend on the strategic behavior of a given country and its neighbors. This behavior assumes the structure of a zero-sum game in which progress is only attainable through redistribution, i.e., for any winner there must also be losers. Without coordination, progress as a whole will not be achieved, however coordination is not the players' preferred strategy.

Over the last six years – plus, in a nutshell, the first weeks of the Syriza government – we have observed a behavior that resembles a 'war of attrition' game that is often used to model the escalation of conflicts. This game involves two contestants who compete for a valuable resource. They do so by resorting to a 'wait-and-see' strategy because the country that moves first and reveals its strategy is fated to be the loser. The main problem with this game is that the players constantly accumulate costs for the entire duration of the contest. In other words, while both players individually have an incentive to wait so that they don't have to give in, this is a strategy that leads to the worst possible outcome globally.

Specifically, while countries on the periphery wait to implement structural reforms until assistance from the core arrives, the countries at the core prefer to wait for structural reforms to be implemented and the periphery to stabilize in order to minimize their own costs. Yet waiting pushes up the negative macroeconomic effects of the crisis even further. Current welfare losses, however, are distributed unequally and core countries such as Germany are much better prepared to wait. This has allowed the rich countries to exercise this strategy – rather successfully – for more than six years now.

Where negotiation has been possible, the behavior typical of power-based negotiation has become apparent. Any redistributed benefits depend on the relative power distribution across the parties involved. This explains why Greece has only been able to receive assistance subject to strict monitoring by the Troika, while the Spanish financial sector received assistance with no such strings attached. The reason for this discrepancy is the systemic relevance to the Eurozone of Spain's financial system; by contrast, Greece is considered a non-systemic risk.

Power-based negotiation mechanisms such as the one described above have significant downsides. They are selective, erratic and always dependent on time and context. That is why current problems can change and challenge the existing sets of rules, leading to enormous instability problems. A prime example of this is the breach of the Maastricht Treaty – not in the shape of Greece's accession to the Eurozone, but in the shape of Germany's and France's breaking of deficit rules in 2002-03. Through their ministers and the ECOFIN Council these countries exercised their power to avoid a penalty. Their behavior rendered the stability criteria irrelevant, turning them into no more than a tool for majority interests in the Council of the European Union. The message this sent to the other Member States was that they should work less on complying with the Maastricht criteria and more on forming alliances to avoid any penalties.

The current crisis and the attempts to resolve it have not only distorted our view of problems such as these, they have also exacerbated the crisis by weakening the power of the European Commission and Parliament. Rather than taking place at Commission and Parliament level, the negotiations happened in the Council, where Member State leaders are clearly on an unequal footing, an imbalance that affects the outcome of every negotiation. Following this mechanism, it is not surprising that the Council has only produced a remedy for the symptoms, rather than the causes, of the crisis. This suggests that when the next crisis arises, which may or may not originate in a then hopefully more stable banking industry, the same old conflict lines will reappear and decisions will be taken based on the same old power relations.

In light of this, and in the absence of binding and enforceable rules, it is hardly possible to predict how the Council would respond to a future crisis. What we do know, though, is that the decision-making process will be conflict-laden and very drawn out, maybe excessively so, due to built-in veto rights. In this respect, the European Union has a systematic competitive disadvantage versus other major trading blocs.

IV. Outlining the Conditions for Structural Reforms: Rule-Based vs. Power-Based Decision-Making

In the context of the situation described above, the solution to the current crisis must be a more comprehensive reform of decision-making structures within Europe. The Council's role and its decision-making process must be adjusted, without prescribing much-disliked centralization. Power-based negotiation must be replaced by a rule-based approach that incorporates clear incentives and evaluation criteria. Ideally, the rule-based approach should be self-enforcing, meaning it should be the best possible option, with power-based negotiation appearing less attractive. This can be achieved through well-designed sanctions. Creating such a mechanism is a difficult and complex task that the European political system must nonetheless tackle in order to avoid stagnation and threatening Eurosclerosis.

The following scenario (if only rudimentarily) illustrates what a mechanism to implement stability criteria could look like. The proposal emulates a mechanism that has been successfully implemented in the General Agreement on Tariffs and Trade, or GATT, and is used in the trade negotiations between GATT members. The mechanism of the GATT is self-enforcing and rests on very basic elements: voluntary participation, the principle of reciprocity, and clearly defined sanctions for Member States that choose to breach the rules.

Adopting a GATT-like mechanism for the Eurozone and using the stability criteria of the Maastricht Treaty as a default could help create better incentives and conflict-solving mechanisms. Countries could pledge to respect deficit targets and/or implement structural reforms provided other countries also agree to do so or if they offer other concessions of equivalent quantity and/or quality. The Member States would have to achieve a consensus on the offered concessions and would each sign an agreement to this effect. If a Member State is found to be noncompliant, the rule-based sanctions would kick in. Most importantly, these sanctions would not be imposed by majority decision (as in the Council under Maastricht Treaty rules) but on a decentralized basis as under the GATT. Member States would decide individually whether to impose said sanctions unilaterally.

Suitable sanctions could facilitate compliance with the mechanism. One possible method would be to cut the agricultural subsidies (specifically, a given country's pro rata share of said subsidies) paid to the Member State in question. Attaching sanctions to agricultural subsidies is an appealing option since farmers have a strong lobby and would put pressure on governments to respect the rules to ensure the subsidies keep flowing.

The rule-based sanctions would be a very clear penalty for noncompliance (in this case, loss of subsidies, domestic political conflict). Since majority-based conflict resolution mechanisms such as log-rolling could no longer be applied in the Council, the Member States would be forced to carefully weigh the cost of compliance (for example, introducing austerity measures) against the cost of noncompliance (for example, becoming sanctioned for an excessive budget deficit). A predefined price tag attached to noncompliance would stabilize political decision-making in the Member States and in turn across the EU as a whole. Strategic zero-sum games would have less of an impact. Importantly, the proposed mechanism includes the option to include escape and exit clauses in cases where the utility of noncompliance is greater than the sanction. Accordingly, the sanctions would have to be set at a level where they would be capable of compensating all other Member States for a given State's noncompliance.

Finally, it is important to state that although the Council and its majority decisions would lose significance, the conflict-solving capacities of the EU would increase without having to centralize decision-making. This would serve the interests of the Member States.

V. Conclusion

The example above, while obviously a simplification of Europe’s complex reality, demonstrates the direction in which the EU’s current conflict resolution mechanisms should develop. To address questions with conflict potential and those that involve redistribution, mechanisms based on voluntary participation, decentralization and reciprocity plus a set of clear rules should be the norm. They would make it possible to move from zero-sum to variable-sum games in a competitive environment in which sound legal rules apply, with interaction between states henceforth only taking place at the economic level. The implementation of such mechanisms naturally challenges the status quo in Europe. Yet when would it be more appropriate to reform EU institutions if not in times of crisis?

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