THE FREE ROAD THAT MUST NOT BE FORSAKEN

Europe's political leadership should remain committed to the legacy of democracy even as it battles a deepening economic crisis, argue Fredrik Erixon and Krishnan Srinivasan.

The great economic boom of the 1990s appeared to Europe's politicians to herald an era of stable inflation and steady growth. This, in turn, justified their precocious dash for monetary unification. Wishful economic thinking led to the belief that a common monetary union under a German central bank-style governed central bank would turn profligate southern European countries into fiscally austere and competitive economies. The elimination of the transaction costs associated with short-term exchange-rate risk in international trade constituted a sufficient argument for doing away with separate currencies, allowing countries to balance out differences in competitiveness through the nominal exchange rate.

But this attitude turned out to be hubris because locking the exchange rate door and throwing away the key left internal devaluation as the only remedy open for the Eurozone crisis. But few governments in the monetary union have the fiscal ability, let alone the political strength, to use it.

The economies of the North Atlantic, and several other countries in the world, have not recovered from the 2008 financial crisis. Fuelled by years of monetary expansion, improper regulations and misplaced beliefs in efficient financial markets, the sub-prime scandals ripped big holes in Western economies. Excesses in the private financial sector triggered the crisis.

But a key factor in the slowness of recovery and the principal generator of unsound debts in Europe is government-made. The distress of the euro is paralyzing economic policy, and there is a global malaise from Europe's self-imposed monetary sclerosis. If the member states of the Eurozone decide to maintain the common currency, as they appear set on doing, they may consign themselves to decades of anaemic economic growth, recurrent deflation and possible sovereign default despite the fiscal and banking unions now being offered as solutions to Europe's dilemma.

The financial imbalances that built up through years of easy money and excessive capital flows into economies with big trade deficits will take a very long time to unwind. European authorities have said for several years that the Eurozone crisis is about to turn the corner, but the stagnation has continued and eaten itself into fiscally well-governed countries. It will take far longer than a business cycle which we are told is the norm.

This time it is different and far worse, because Europe's economy will be weighed down by falling consumption and by the need to deleverage household debts and pay down government debt. That will require a decade-long effort, at best. Can Europe's democracies and institutions cope during this period of economic stagnation?

Predicting Europe's political future is as difficult as predicting the economic solutions it may propose for the euro crisis. For the moment at any rate, the doctrine according to Berlin is austerity and more austerity, and rapid fiscal adjustment seems the only way to persuade the German voters to help bridge the gap. They have to be convinced that the need for responsibility and prudence has been well established across the north Mediterranean, and that they will see their loans returned to them in full. It is, in fact, unlikely that they ever will. Time will probably introduce the realization that demanding a guarantee of austerity and full repayment is likely to be a worse remedy than the debt write-downs that will get economic growth surging again.

But that is only the start. Many possibilities will open out even after unremitting austerity has been abandoned and Europe will be left with three alternative options: to break up the Eurozone, to carry on as before with further painful bail-outs and write-downs, and, lastly, federalism. Of these three, the first and last, obviously, have far-reaching implications.

If the social and economic consequences of a break up follow a pre-determined model, it would be easier to assess the consequences. These range from a catastrophic humanitarian crises, a retreat to protectionism and an escape-route to exchange rate flexibility. The first step on the current Eurozone agenda is a banking union. But even here, the uncertainties loom large. The French, Italians and Spanish fear the loss of sovereignty a fiscal and banking union would impose, while the Germans, though demanding stricter control of other countries' banks as a price for their support, fear they will end up being out-voted and forced to pay to save banks in other countries. Consequently, Germany has become increasingly hostile to the idea of a comprehensive banking union.

For the United Kingdom, any federal solution could lead to self-exclusion, which will not be a pleasant prospect. Leaving aside the rhetoric of quitting the European Union, which was to outflank the Eurosceptic elements in Britain's political firmament, it is quite another matter to part company with a regional bloc accounting for half of Britain's trade.

If, in the time-honoured manner, Europe sticks to the middle path, will its democracies manage to adjust? In a way, they will have no other alternative. There is not one Eurozone country where the population wants to quit the euro, no single government in the Eurozone that wants to either, and there is no EU member, apart from Britain, that seems to contemplate a life outside the union. And to stay in means to remain on the democratic path. The large number of voters who have voted for parties of the far right and the far left and for some of the new and indeterminate outfits like the Italian Five Star Movement founded by the comedian, Beppe Grillo, have to reckon with this reality. This is because Europe, for all its faults, is an extraordinary political achievement, not for its hydra-headed institutions in Brussels, but for its fundamental commitment to individual freedoms, the rule of law, human and civil rights and negotiated and mainly consensual political solutions. This has resulted in nearly seven decades of democratic development which is now considered deep rooted.

That is a huge base of political capital even if it does not guarantee democratic survival. The countries with the greatest economic troubles like Greece, Italy, Spain and Portugal have moved from stable and frequently single-party governments to messy, multi-party systems and coalition instability. For a time, at the prodding of Brussels and Berlin, Italy had to give up on party government in favour of the former premier, Mario Monti, and his technocrats. When Monti decided to contest a general election, the voters decisively voted against him and austerity. Already there is a democratic deficit whereby Greeks and Cypriots elect leaders unable to take independent economic decisions. Members have to forego full sovereignty for fiscal stability; the trilemma is to manage inflation, finances and the debt along with national politics and the global market.

Democracy, as India knows so well, is never easy during hard times. National politics is usually a long and messy grind. What does not seem to be a good idea in the European circumstances is to compound these troubles by making a dramatic push for EU political centralization in the mistaken belief that the poorer parts of Europe will reap a fiscal bonanza from a benevolent Germany. That will not happen, because nobody is ready for a political union. Despite the need for debt write-downs, no feasible amount of fiscal federalism will do much to alleviate southern Europe's current economic troubles. As class, sectoral and inter-generational tensions in those ailing countries are painfully worked out, there will be a better chance of success if the voters in each country see the process mainly as the evolution of an internal bargain rather than as a national battle against an unsympathetic Brussels and Germany that want the EU members to live by their rules.

In many European countries along the north Mediterranean, times will be very tough as is evidenced by the recent banking crisis in Cyprus. Smaller European nations like Ireland and Iceland (though not in the EU) have the resource of cohesion that comes from being confident and determined in their identity. But bigger nations like Greece, Italy, Portugal and Spain have a harder task. There is no guarantee that domestic politics will be able to deliver what is needed, and politics can destroy a country's prospects when badly managed, as India knows to its cost at national and state levels. On the other hand, politics can also deliver lasting solutions through consent, and not imposition.

In Europe, many pundits today believe in big and quick fixes like dissolution or federalism. The debate is being fanned by extreme and unrealistic views. It is North versus South, Europhiles versus Europhobes, deep austerity pitted against Keynesianism, free market radicalism against big government expansionism. None of them is a real alternative that can address the crisis. These arguments distract attention from the need for responsible political leadership, embracing rather than disavowing democratic legitimacy.

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