The Euro And Schengen: Common Flaws And Common Solutions

This article, written by Professor Paul de Grauwe of the London School of Economics, was brought to our attention by Dr Anthony Coughlan of Dublin. It illustrates the threat to national sovereignty that both the EU's flagship projects pose.

What do the Euro and Schengen have in common? Both are projects that have the same flaw: they're unfinished business. And therefore they risk falling apart.

The Eurozone is a monetary union, with one currency, the euro circulating in the Union and managed by one central bank, the European Central Bank. What's wrong with that? One may ask.

The fundamental problem of the Eurozone is that national governments have their own budgets and issue their own debt. When recession strikes, the system gets into trouble. During a recession government budget deficits automatically increase. Countries that are hit hardest by the recession show larger budget deficits and debt increases.

Financial markets that are fully integrated in a monetary union are lurking, ready to strike when observing signs of weakness. Countries hit hardest by the recession experience "sudden stop": investors massively sell the government bonds, raising the interest rates and pushing these countries into illiquidity.

The other countries in the system profit from this, as investors in search of a safe haven buy these countries' government bonds. Thus during recessions, free capital movements destabilize the Eurozone and plunge the weaker countries into a "bad equilibrium" of ever deeper recession and rising unemployment.

What about Schengen? As the Eurozone, it is an unfinished project. The residents of the Schengen area move freely within the area. The problem is that the architects of that area forgot to integrate the police and the intelligence services. Moreover, they forgot to transfer the authority to control the external borders to one European body.

As a result a problem arises in the Schengen area that is similar to what happens in the Eurozone. Criminal gangs move freely within the area. They commit burglaries in one country and flee to another one. In contrast police forces have to stop at borders. Terrorists are planning from Brussels how to attack Paris and escape from the radar of the national police forces and intelligence services. National police forces and intelligence services are not integrated and can no longer guarantee the security of their citizens.

The danger of unions that are unfinished is that they will disintegrate. Without a fiscal union free capital movements will create great instability when the next recession strikes the Eurozone. In the long run, governments that can no longer guarantee a minimum of economic stability to their citizens will be tempted to leave the Eurozone.

The choice we have today is simple. If we want to keep the Euro we will have to create a fiscal union. This implies that a significant proportion of national budgets and national government debts will have to be centralized. A formidable transfer of sovereignty from the nation states to European institutions. If we want to preserve the Schengen area, we will have to integrate police forces and intelligence services while creating a joint control at the external borders. Failure to integrate further dooms both projects, the Eurozone and the Schengen area.

The Eurozone and the Schengen area have fundamentally weakened national governments while nothing has been put into place at the European level to offset this loss of power of nation states. The Euro and Schengen can only be saved if we create European institutions that can do what national governments no longer can do, i.e. to ensure economic stability and security for the citizens of Europe.