WHAT SCHENGEN CAN LEARN FROM THE EURO CRISIS

IED Research Project: "Migration, borders control and solidarity: Schengen at stake?"

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Abstract: *This paper identifies five key lessons of the euro crisis with implications for the Schengen area. Assessing economic and political costs of disintegration in both cases, it concludes that path dependency is present and also decreases probability of a permanent dismantling of the passport-free area. Looking at the development of necessary institutions for risk sharing, the Eurozone provides an example for incremental progress, with reform efforts losing momentum once the pressure eases. Both crises showed patterns of "go it alone" strategies, with self-seeking actors giving up on mutually beneficial outcomes; for these, Member States need to invest in rebuilding trust and bringing polarized positions closer. In both cases, fundamental problems cannot be addressed without an agreement over a crisis narrative and common approaches to the policy fields in question, including a common ground on immigration and refugee policy. Crisis management mechanisms need to be bolstered, with non-majoritarian institutions only used as a last resort.*

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Introduction

Spending many college summers traveling across Europe – getting to know people and places, tasting local specialties and taking on summer jobs along the way – I developed a strong commitment to the borderless Europe. The Schengen Agreement which provides for the absence of border controls is not only cherished by the Interrail Generation,[1] though. Guaranteeing the free movement of 400 million people from 26 European countries, integrating much of the long separated former socialist East; it is nothing short of historical. It has also become indispensable for Europe's citizenry and economy.

As the Eurozone is still crumbling under repercussions of the global financial crisis, the year 2015, which brought about an upsurge in the arrival of asylum seekers and tragic terrorist attacks in Paris and Brussels, sadly unveiled that the passport-free zone – in striking resemblance to the common currency – is a 'fair weather construct': only fully functional if Europe's neighboring regions or financial markets are stable.[2]

Both crises had their origins outside of the EU – the Eurozone was shaken by the US subprime mortgage crisis, while Schengen came under pressure due to civil wars in the Middle East and North Africa.[3] These outside pressures shed light on the fundamental design flaws of these two highly appreciated hallmarks of European integration. As theorized by Kathleen McNamara, they exposed the Eurozone's lack of embeddedness in financial, fiscal and governance institutions[4] and the Schengen area's lack of embeddedness in a common internal security regime.[5] Unfinished constructs of this kind are dangerous because they can be catalysts for crisis by themselves. National level instruments for adjustment and shock absorbance are out of reach already, but European institutions are not (yet?) set to take their place.

As the stakes are so exceptionally high, it is evermore advisable to turn our attention to the first half of the decade, which saw the European Community grappling with the crisis of the Eurozone. Because of the common features of the two crises outlined above, the lessons from the euro crisis can be illuminating in our effort to understand the complex challenges facing the Schengen area.

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[1] The Economist, 2015b
[2] Schimmelfennig, 2015; Lehne, 2016
[3] Schimmelfennig, 2015
[4] McNamara, 2015d: 1
[5] McNamara, 2015b

The aim of this paper is to identify the main lessons of the euro crisis with implications for the Schengen area. For this endeavor, I present an analytical framework, based on conceptual tools from international political economy. The paper is structured as follows. I highlight five key lessons from the euro crisis, investigate the parallel with the present situation in each case and draw the inferences relevant for reforms and a future crisis management effort for Schengen.

The following table summarizes the relevant euro crisis lessons identified, categorized as either a positive or negative example for Schengen, and matched with their implications. Overall, the Eurozone crisis is not a positive example for effective crisis management, but even in case of the negative lessons, there are mistakes to be avoided and learned from.

Table 1: Summary of findings[6]

	LESSON	POSITIVE/ NEGATIVE	IMPLICATION
1	Prohibitively high economic and political costs of disintegration create path dependency and provide incentives for cooperation.	(+)	A permanent dismantling of the passport-free area has high economic and political costs, which decreases its probability.
2	Developing necessary institutions for increased risk sharing incrementally proceeds under growing pressure.	(+) / (–)	The Eurozone's progress in creating risk sharing capacities is a positive signal for Schengen, but delaying action and leaving reforms unfinished should be avoided.
3	The system is prone to 'go it alone' solutions based on narrowly defined self-interest, which are suboptimal on the long run.	(–)	For positive-sum outcomes, Member States need to invest in rebuilding trust and bringing polarized positions closer. Otherwise, core countries interests are likely to

[6] own compilation

			prevail by coercion.
4	Fundamental problems cannot be addressed without an agreement over a crisis narrative.	(–)	Common approaches to the respective policy fields need to be worked out, including a common ground on immigration and refugee policy.
5	In the dire need of functional governance and crisis management mechanisms, there is a reliance on non-majoritarian decision making.	(–)	For stronger legitimacy and more efficiency, crisis management mechanisms need to be bolstered with non-majoritarian institutions only used as a last resort.

LESSON 1: Prohibitively high economic and political costs of disintegration create path dependency and provide incentives for cooperation.

Negative/ positive: (+)

In case of both the Eurozone and the Schengen Agreement, economic and political costs of a possible breakup are prohibitively high. When assessing possible outcomes for Schengen based on the experiences from the euro crisis, the first important conclusion is that these costs provide a strong incentive for cooperation, decreasing the probability of a permanent dismantling of the passport-free area.

1.1 Lessons from the euro crisis

Macroeconomist Barry Eichengreen famously claimed that the euro is "practically irreversible": reintroducing national currencies would trigger "the mother of all financial crises" with a system-wide bank run, a bond market crisis and formidable procedural costs – the need to redenominate all existing contracts throughout the land, for instance.[7] It is quite telling that there is hardly any serious impact assessment research on a complete breakup scenario with a continent-wide reintroduction of national currencies. There are rough estimates for partial breakup scenarios, for instance single country exits. The expected costs arising from sovereign and corporate defaults and trade collapse are immense, especially in the transition period, and are generally seen as outweighing expected benefits of regaining monetary policy independence (thereby the option of currency devaluation to boost competitiveness) and escaping a suboptimal currency area.[8]

Domestic political risks of a Eurozone breakup are insurmountable. A chaotic transition with severe economic losses may trigger political instability and civil unrest, giving rise to extremist parties or outright authoritarian regimes.[9]

[7] Eichengreen, 2007

[8] According to UBS researchers, if a periphery country was to exit, based on precedents in Argentina or Uruguay, its currency would depreciate by 50 to 60%, sovereign and corporate default would trigger a dramatic surge in risk premiums, trade volumes would decrease by 50% and the banking system's collapse would entail further costs (Deo et al., 2011: 10). In case of a core country's exit, though sovereign default is not anticipated, corporate default, bank recapitalization and the collapse of international trade would still cause a loss of 20 to 25% of GDP in the first year. (Deo et al., 2011: 1) Others, such as Paul Krugman argued that in the Greek case, by the summer of 2015, the worst part of the exit (financial meltdown) had already happened, so the benefits of devaluation could indeed be reaped. He cited Icelandic (2008-2009) and Argentinian (2001-2002) devaluations as positive examples. (Krugman, 2015)

[9] Deo et al., 2011: 15

According to the Eurobarometer surveys[10], public support for the euro among Eurozone citizens remained favorable throughout the crisis. In the latest 2015 survey rounds, 61% of Eurozone residents considered the euro as a good thing for their respective countries.[11] Looking at cross-country variance, lowest scoring Italy (49%) and Cyprus (50%) are the only euro members where positive attitude towards the common currency did not have a majority.[12] Data from other pollsters such as the Pew Research Center are in line with these findings – they found that even though only one third of Greeks have a favorable opinion of the European Union, 69% of them wanted to keep the euro.[13] Therefore, political leaders held responsible for disintegration would likely to expect popularity costs.

So unilateral exit is not likely, but how about expelling or forcing periphery Member States to leave? After all, German finance minister Wolfgang Schäuble did float the idea of a temporary exit for Greece.[14] In this case, an important point is that it is not only the exiting country bearing the costs – other euro members with trade exposure would suffer losses and creditors would likely to lose on their claims. Researchers of Bruegel concluded that even in case of a Greek default, direct losses for creditors would be larger if Greece was to exit the common currency than if Greece was to remain.[15]

However, the dire negotiations surrounding Greece's third bailout package in the summer of 2015, culminating in a near Greek exit, presented a frightening case study for how the different actors perceive these costs. The multiple rounds of chicken games have shown that both parties are willing to go surprisingly far in jeopardizing a mutually beneficial outcome.

1.2 Implications for Schengen

Although the breakup of Schengen may not threaten with short-term disruptions as severe as systemic bank runs, it would similarly present a major economic blow, especially on the long run. The absence of border controls facilitates trade: an empirical study estimated Schengen's positive impact on bilateral trade flows to be 10 to 15%.[16] A French government

[10] European Commission, s.a.
11 Flash Eurobarometer 405, 2014: 8 – see Appendix
12 Flash Eurobarometer 405, 2014: 8 – see Appendix
13 Pew Research Center, 2015
[14] Schäuble in: Karnitschnig, 2015
[15] Darvas and Hüttl, 2015
[16] Davis and Gift, 2014 in: Aussiloux and Le Hir, 2016: 10

think-tank France Stratégie estimated permanent border controls to be equivalent to a 3% tax on trade. Concentrating on the increase in the price of exports, Swiss-German think-tank Prognos AG estimated an accumulated 0.04 to 0.12% GDP loss for 24 EU countries[17] until 2025 (€ 470.5 billion and € 1430.1 billion, assuming 1% and 3% increases respectively). France Stratégie projects a 0.8% (more than € 100 billion) decrease in the area's output over the next decade, if the passport-free zone was permanently demised.[18]

Further negative impacts on short-stay tourism (the number of intra-EU one night visits was 218 million in 2013, 11% of which on business)[19], labor mobility (around 1.7 million Schengen residents are cross-border commuters)[20] and freight transport must be addressed. Assuming an extra waiting time of one hour and a commission charge of € 55 per vehicle, the Association of German Freight Forwarders and Logistics Operators (DSLV) fear a yearly cost increase of € 3 billion.[21] Many point to the potential disruption of just-in-time delivery systems, forcing companies to build up costly storage capacities. Regional supply chains would suffer as well.[22]

The reintroduction of border controls may be managed in a more orderly way than national currencies, resulting in a smaller disruption of political stability, but it could certainly reinforce populist parties' agendas all over Europe. It is interesting to observe how liberal ideas supporting open borders and the free movement of people are being attacked by populist parties throughout the West. The appeal of raising barriers is a general pattern among them.[23] US presidential nominee Donald Trump campaigns with a wall along the Mexican border and a ban on Muslims entering the country, France's Marine Le Pen advocates for economic barriers, Viktor Orban's Hungarian government has erected a razor-wire border fence and even asylum seekers face criminal charges in case of unauthorized entry through it.

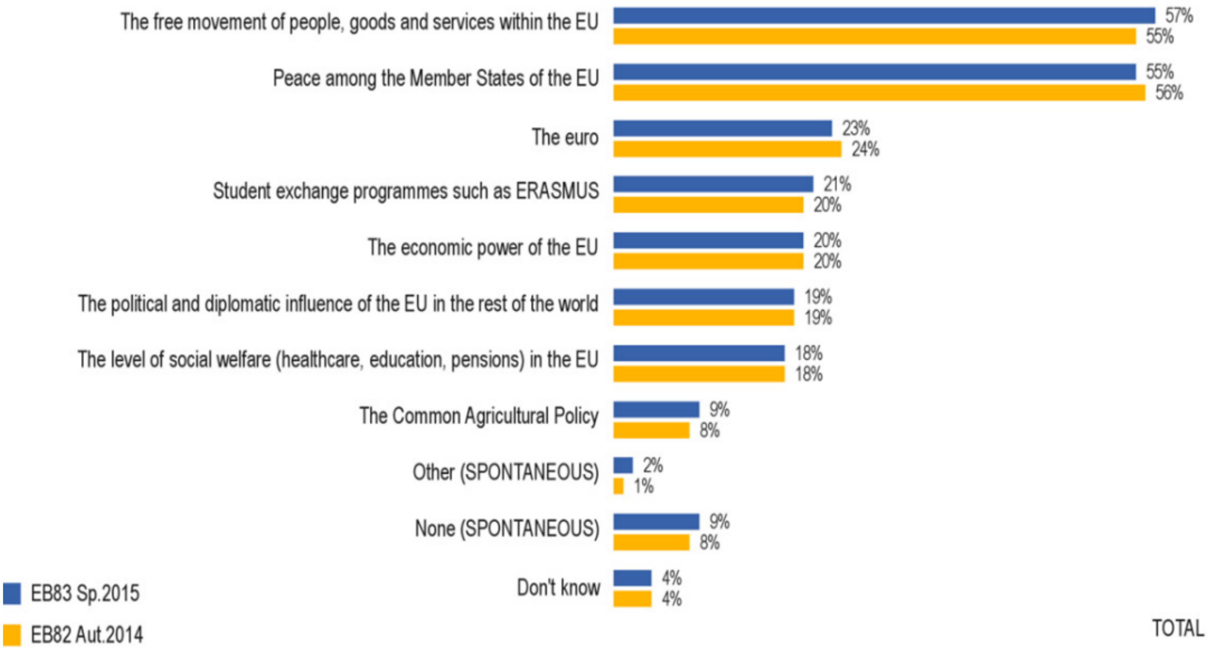
Since the free movement of people is an even more strongly appreciated achievement among the electorate – the 2015 Eurobarometer survey results show that it has the highest

[17] Luxemburg, Malta, Cyprus and Croatia excluded
[18] Aussiloux and Le Hir, 2016: 1
[19] Boot and Wolff, 2015
[20] Boot and Wolff, 2015, The Economist, 2016
[21] Deutscher Speditions- und Logistikverband e.V., 2016
[22] Böhmer et al., 2016: 6
[23] The Economist, 2015

ranking among positive results associated with the EU (see Figure 1) – popularity costs of the Schengen Agreement's abolition can be expected to be higher. [24]

Figure 1: Which of the following do you think is the most positive result of the EU? Firstly? And then? [25]

Total of the "Firstly" and "And then" answers (maximum 3 answers)



Making these costs even more severe is the general fear of the integration process changing course and giving way to disintegration.[26] The common currency and the absence of border controls are the strongest symbolic achievements of the unification project which is up until now seen as an uninterrupted, linear progress. Even a single country's exit from the euro or the passport-free zone is damaging the irrevocability of these achievements and the credibility of Member States' institutionalized commitments in general – towards each other and foreign partners, in various other fields too. If this progress stops and relapse starts, where will it stop? Is *peace*, the other highly appreciated accomplishment of European integration endangered as well?

[24] Ademmer et al., 2015: 4
[25] European Commission, 2015: 31
[26] The Economist, 2015

Kathleen McNamara coined the expression ‘Everyday Europe’ to refer to common European symbols and practices that are crucial to citizens’ day to day lives. Throughout decades of integration, there has been a slow but steady accumulation of such “labels, mental maps, and narratives” framing a common European space.[27] She argues that this reframing or Europeanization of everyday experiences constitutes a natural foundation of the European Union’s political authority. The Eurozone and the Schengen Agreement (even though it is not officially an EU treaty and also has 4 non-EU signatories[28]) are the cornerstones of the European Union’s cultural infrastructure. Their failure, therefore, is strongly linked to the weakening of European governance itself.

Since political decision-makers are generally seen as short term utility maximizers, it is unlikely they would sacrifice popularity through bearing the immense economic and political costs inherent in the disintegration of both the common currency and the passport-free zone.

[27] McNamara, 2015a: 3
[28] McNamara, 2015b

LESSON 2: Developing necessary institutions for increased risk sharing incrementally proceeds under growing pressure.

Negative/ positive: (+) / (–) (incomplete progress)

Both the Eurozone and the Schengen Agreement are examples for incomplete integration, lacking risk sharing capacities which make a well-functioning monetary union and passport-free area possible in the first place. In their present form, both are halfway houses prone to crisis. Above, we established that moving backwards from halfway is extremely costly, so there are strong incentives for more centralization. During the euro crisis, in spite of a strong German-lead opposition, important steps were taken towards increased risk sharing – by the policy change of ECB President Draghi and the setting up of a banking union.[29]This is a positive signal for Schengen reform proposals, but it would be highly advisable to avoid the "too little, too late" type of solutions born out of desperation.

2.1 Lessons from the euro crisis

The Centre for Economic Policy Research launched a project called "Rebooting Europe", summoning "a dozen leading economists from across the spectrum" – including, for instance, former IMF chief economist Olivier Blanchard – to agree on a shared narrative about the causes of the crisis and the ways forward.[30] Part of their consensus narrative is that a monetary union takes away shock absorbing instruments from Member States, so the euro can only survive if they are substituted by capacities for Eurozone-level risk sharing.

Firstly – according to the project's two authors, Eichengreen and Wyplosz – there is a need to centralize so-called 'backstop facilities', the ECB acting as a lender of last resort behind sovereign bond markets preventing (even otherwise solvent) economies from sinking into a self-fulfilling default loop in case of sell-offs.[31] Greece's public finance meltdown in 2009 could detonate a crisis of this magnitude because it "alerted financial markets to the risk of a sovereign default in a system where the provision of liquidity to ensure the orderly rollover of distressed sovereigns is not guaranteed".[32] The Trichet-lead ECB failed to provide these facilities, deepening the devastating consequences of the crisis. Mario Draghi's assertion in the summer of 2012 to do "whatever it takes to save the euro" was a forceful

[29] Eichengreen and Wyplosz, 2016
[30] Baldwin et al., 2015
[31] Eichengreen and Wyplosz, 2016
[32] Micossi in: Baldwin and Giavazzi, 2016

move towards risk sharing; basically promising markets to buy distressed sovereigns bonds to keep the Eurozone together.[33] It is interesting lesson how it came at a point when contagion spread to the core, threatening with a blowup of the currency area and possibly the whole of the EU.[34]

A similar step, out of desperation, was the decision to create a banking union with the Single Supervisory Mechanism. This is the second minimum condition named by Eichengreen and Wyplosz. Since banking sector stability is a common good, centralized provision is justified. Apart from the necessary advances in financial regulation, the failure of which was at the heart of the building up of imbalances, a complete banking union needs to have a fiscal dimension as well: a common deposit insurance scheme. A fund of pooled resources to insure bank accounts was until now rejected based on fears of fiscal transfers to imprudent Member States.[35] Economic analysis suggests the need for increased risk sharing in this case as well.

Since optimal solutions like a full fiscal union are a political impossibility (diverging Member State preferences do not support a full fiscal union either[36]), institution-building proceeded in a much slower pace, without the prospect of quantum leaps in integration. One should look for the minimal set of conditions that provides a gradual way out of the present turmoil and strategies to make the necessary advances in integration, by turning, for instance to the EU's renowned 'muddling through'[37] or 'functionalist'[38] integration strategy. As Charles Wyplosz sharply noted – "arguing for a fiscal union or a political union is the intellectually lazy response."[39]

Most economists argue that the minimal conditions for a functioning euro area are still a long way ahead, but important steps were taken in the right direction what Eurozone-wide risk sharing is concerned.

Integration of core government functions in the multi-level polity of the European Union was empirically assessed in the recent edited volume of Philipp Genschel and Markus

[33] Baldwin and Giavazzi, 2016
[34] Ibid.
[35] Eichengreen and Wyplosz, 2016
[36] Ibid.
[37] Barysch, 2014
[38] Wyplosz, 2015
[39] Ibid.

Jachtenfuchs.[40] Their framework differentiates between regulation and capacity building – finding that integration did succeed through regulatory instruments after the crisis (such as the successful regulation of budget deficit), but capacity building was very limited. One important lesson is also the need for capacity- and institution-building as well.

2.2 Implications for Schengen

In the edited volume of Matthias Matthijs and Mark Blyth, authors use the term 'forgotten unions' to refer to the missing financial, fiscal and governance frameworks needed for a functioning Eurozone.[41] What are the forgotten unions in case of the passport-free zone? The most important one would certainly be the system of external border controls, which is momentarily up to varying approaches of individual Member States. There is an agency in charge of coordinating border control – Frontex[42] – but it is merely a coordinative scheme of the national agencies, with limited funds and powers; depicted as "toothless" and "much maligned" by observers.[43] It is quite telling how Fabrice Leggeri, Frontex's executive director commented recent plans to increase funding and powers of the agency: "We have lost a decade. (…) In the last decade, something should have happened."[44] The budget of Frontex was a mere € 143 million in 2015, increased to € 254 million in 2016.[45] As a comparison, the US Customs and Border Protection agency had a $ 12.8 billion budget in 2015 and $ 13.6 billion in 2016.[46] Frontex currently does not have means or authority to access security databases and exercise even simple screening mechanisms[47] and it serves as a coordinating body between national agencies, but cannot issue orders to them.[48] So an important improvement in risk sharing should be the strengthening the EU's Frontex agency – both with more funds and more power.

Burden sharing in case of Schengen's crisis immediately evokes the serious imbalances among Member States in their willingness to host refugees. The need for

[40] Genschel and Jachtenfuchs, 2014
[41] Matthijs and Blyth, 2015
[42] The official name of Frontex is European Agency for the Management of Operational Cooperation at the External Borders of the Member States of the European Union
[43] Foy and Robinson, 2015
[44] Leggeri in: Foy and Robinson, 2015
[45] Frontex, 2016
[46] United States Department of Homeland Security, 2016
[47] Mortera-Martinez, 2016: 9
[48] Eichengreen, 2015

solidarity appears in several dimensions. Honoring their humanitarian commitments, Schengen countries need to take their fair share of hosting people in need. Overwhelmed frontline countries – bearing the sole responsibility to process asylum seekers under the Dublin regulations – need support from others. While core countries refugees are striving towards need the periphery to host people as well. As the Dublin framework proved to be both inapplicable and unfair, there is a need for a sustainable relocating mechanism.[49] One innovative proposal outlined a market for tradable admission quotas paired with a mechanism for matching which takes refugees' preferences into account as well. According to the author Moraga Fernández-Huertas, "[t]he system would distribute refugees to the countries where it is less costly to host them, while ensuring that refugee rights are respected, in the sense that no refugee would be forced to relocate to an undesired destination."[50]

Another important field where there are calls for centralization is the very sensitive area of internal intelligence and data sharing.[51] Currently, Schengen countries use multiple databases to identify their citizens and foreign nationals. There are centralized ones such as the Schengen Information System (SIS) storing alerts on wanted and missing persons and objects or Eurodac which contains fingerprint information of asylum seekers, while DNA information and fingerprints are also stored in national databases (Prüm). Camino Mortera-Martinez of the Center for European Reform urges for investment in the technology to integrate these for a faster and more effective screening process without bureaucratic hurdles, but abiding by the EU's strict privacy standards.[52]

As a step to strengthen counterterrorism intelligence, in April 2016, the European Parliament passed legislation to create an EU-wide system of accessing Passenger Name Records (PNR) to prevent and combat terrorism and serious crime – in spite of being criticized by some human rights advocacy groups. The proposal (first introduced in 2007 but continuously blocked ever since) counts as an important example for the tendency of centralization and the pooling of resources.[53]

[49] Lehne, 2016
[50] Fernández-Huertas Moraga, 2016: 9
[51] McNamara, 2015b
[52] Mortera-Martinez, 2016: 10-12
[53] BBC News, 2016

The Eurozone example also shows that it is extremely difficult to concentrate on institution building while being forced to do short term fire-fighting.[54] One implication of this is that – although the Eurozone crisis projects a positive lesson about the possibility of progress under pressure – it would be advisable not to wait for the final hour of desperation to take the necessary steps of institution building. However, in case of the Eurozone, reform efforts seemed to lose momentum once the pressure was eased.[55]

In the meantime, intensive work needs to address the more short term challenges. Camino Mortera-Martinez[56] proposed a five-point plan of such short term interventions:

1. Making hotspots work by providing more funding, personnel and equipment to overwhelmed Greece and Italy, thereby creating a faster processing of asylum-seekers.
2. Alleviate political pressure by first ensuring effective external border security so that an agreement on a functional reallocation mechanism becomes possible.
3. Establishing asylum processing centers in third countries and provide more humanitarian visas (also at embassies) so that asylum seekers are not incentivized for dangerous and illegal crossings to Europe.
4. By providing incentives for third countries, returning as much failed asylum seekers as possible to their country of origin or transit.
5. Integrating Schengen databases to be able to process information about criminal people and suspects, keeping them out or executing them.

[54] Baldwin et al., 2015
[55] Lehne, 2016
[56] Mortera-Martinez, 2016

LESSON 3: The system is prone to 'go it alone' solutions based on narrowly defined self-interest, which are suboptimal on the long run.

Negative/ positive: (–)

Grappling with the crisis, the Eurozone ultimately ended up in a prisoners' dilemma situation in which Member States maximized their own short-term gains while giving up on greater longer term mutual benefits of cooperation. Leverage-based politics and zero-sum negotiations continued in the aftermath of the refugee crisis as well, projecting gloomy prospects. When assessing relative bargaining power in the core-periphery dynamics, core countries prevail, so cooperation may emerge as a coercive outcome. For a comprehensive, positive-sum outcome, Member States need to invest in rebuilding trust and bringing polarized positions closer.

3.1 Lessons from the euro crisis

The euro crisis, especially the negotiations of Greece's third bailout package in 2015 provides a sobering negative example for the detrimental effects unilateral and self-interested moves have on trust and cooperative spirit between parties.

In an environment like that, it became tragically impossible to find a positive-sum compromise striking a balance between Greece having to pay for imprudence, signaling the Eurozone is a force for discipline, but not pushing the country's economy into pointless, devastating austerity damaging growth prospects and giving a boost to extremist political parties. An overwhelming number of leading economists have since then denounced Germany's ordoliberalism, the burden of adjustment being put exclusively on the periphery and the German-led core choosing to decline calls for more solidarity.[57]

Germany strong-arming Greece into terms of the third bail-out was denounced as a "political cage match" by Eichengreen,[58] a "brute power play" by McNamara[59] and even Germany's claim "to transform the Eurozone from a European project into a kind of sphere of influence" by Joschka Fischer.[60] All this probably contributed to the fact that Germany's calls for more cooperation, solidarity and burden sharing during the refugee crisis were also left unanswered.

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[57] Matthijs, 2016
[58] Eichengreen, 2015
[59] McNamara, 2015c
[60] Fischer, 2015

The bad faith of Greece's Syriza government was apparent as well, with both prime minister Alexis Tsipras and finance minister Yanis Varoufakis playing the 'chicken game' based on the assumption that their creditors are determined to keep the Eurozone together (see Lesson 1), at points using outright blackmailing tactics.[61] The Tsipras government irresponsibly promised its electorate to undo even positive and finally growth-enhancing reforms of their predecessors (there were in fact positive results of the EU-policy) while paying no costs for it. Mr Tsipras called a referendum on the creditors' terms, presumably just to signal commitment in the chicken game. But Greeks turning to populism was already a reaction to devastating costs – a quarter of Greek GDP lost in five years, and half of the young workforce unemployed.[62]

With the breakdown of institutions navigating Member States to a possible harmony of interests, European politics relapsed into a pure realist power struggle, where outcomes are based on the relative bargaining power of one side over the other.

<u>3.2 Implications for Schengen</u>

The immediate aftermath of the refugee crisis followed the dystopian guidelines of the euro crisis, certainly not independently from it. As weaknesses of the system became evident and there was no effective collective decision making mechanism in sight, Member States turned to "go it alone" type of strategies, often openly harming the interests of their neighbors.

Overwhelmed frontline countries failed (and after a time: refused) to comply with the Dublin framework registering asylum seekers, but let them through to pass freely to their original destinations – prosperous and migrant-friendly countries like Germany and Sweden. Hungary (unable to provide for even transiting asylum seekers, who were stranded at train stations) was first to selectively close its border with a razor-wire fence in order to divert the flow of people, but others followed suit as well. This was also the point when the real existential threat to Schengen arose – Member States' unilateral actions extended to reimposing temporary border controls to slow down the flow of people and regain control.[63] At this moment, the European Commission's Migration and Home Affairs website lists

[61] The Economist, 2015
[62] Ibid.
[63] Lehne, 2016

temporarily reintroduced border controls in Denmark, Norway, Sweden, France, Germany and Austria.[64]

Cleavages between Member States became more and more accentuated, the Visegrad countries – vocally hostile against hosting refugees – grouped together, while a smaller "coalition of the willing" including the Benelux countries, Finland, Germany, Greece and Sweden started to hold separate gatherings.[65] Angela Merkel's strong moral statement of a *Wilkommenskultur* was praised by many, while harshly criticized by others.

The peculiarity of the German position is that this time, they are the ones requesting solidarity and are denied of it, while periphery countries – this time, the Visegrad group – seem to hold the leverage. It is important to note, however, that Germany is still the biggest economy in Europe, and core countries have unused bargaining chips. Structural and cohesion funds from the core to the periphery, a vital lifeline especially in the Hungarian case, could be a coercion instrument that was already floated by German and Austrian officials.[66] Oddly, Schengen itself could turn into a bargaining chip. The Dutch proposal about a "mini-Schengen" with enhanced cooperation among Germany, Austria and the Benelux states could be a devastating consequence for the East, both economically – increased labor costs could endanger jobs in cross-border production chains (since many Western companies opted for the region due to the cost differential) – and in its enormous symbolic importance for the former socialist East. Therefore, preferences of core countries are likely to prevail.

Strengthening of the EU's border and coast guard is also a vital interest of periphery countries who could thus be incentivized to agree to a relocation mechanism and host their share of refugees.

[64] European Commission, Migration and Home Affairs, s.a.
[65] Lehne, 2016
[66] Tagesschau Online, 2015

LESSON 4: Fundamental problems cannot be addressed without an agreement over a crisis narrative.

Negative/ positive: (–)

There were important steps addressing the fundamental design problems of the Eurozone, but there are many flaws that remain to be fixed. The Eurozone, in its present form, is not likely to be able to weather a next economic storm. It is problematic that there is no agreement over a crisis narrative – whether we were dealing with a sovereign debt crisis or that deeper design flaws and excessive lending and borrowing gave rise to a sudden stop crisis.[67]*In case of Schengen, Europe may be dealing with a foreign policy crisis that can be effectively tackled by a common approach to foreign affairs and capacities to follow through on it. Integration of security and defense policies promises to be a difficult step. Finding a common ground on immigration and refugee policy, however, seems to be an almost hopeless endeavor.*

4.1 Lessons from the euro crisis

As the pack of leading economists behind CEPR's crisis narrative eloquently put it, "it is impossible to agree upon the steps to be taken without agreement on what went wrong".[68] Unfortunately, it is still heavily debated whether the euro crisis should be seen as a sovereign debt crisis or a balance of payments (sudden stop) crisis.

CEPR's crisis narrative argues for the latter. Assessed from this angle, one fundamental problem is that the Eurozone is not an optimal currency area (theorized by Robert Mundell[69]) – it incorporates economies with different levels of development, also requiring different interest rate levels. This opens the possibility of asymmetric shocks – a core country being affected by an exogenous impact in a different way than a periphery country – while distinct adjustment instruments of monetary policy are out of reach within a monetary union. This can be a catalyst of crisis in itself – it contributed to real estate bubbles in Spain or Ireland, creating enormous current account imbalances.[70] This root cause is of course not possible to remedy – assuming that the Eurozone holds together.

[67] Baldwin et al., 2015
[68] Ibid.
[69] Mundell, 1961
[70] Baldwin and Giavazzi, 2016

Real convergence between these economies of the core and periphery would be the only way to solve the problem, but full convergence is not a realistic prospect in the coming decades. However, it is also questionable whether we should concentrate on 'optimality' to this extent. Other monetary unions throughout history, the United States for instance, also functioned with differences in real economic development.

There are many ways to prevent detrimental imbalances – financial and macroprudential regulations were mentioned above and were also addressed to a certain extent. If imbalances are there, common risk sharing mechanisms (also mentioned above) help the adjustment process. More flexible labor and product markets would help Member States adjust domestically, while Eurozone-wide labor mobility, more integrated markets and enhanced competition would decrease the occurrence of asymmetric shocks and also would facilitate the adjustment in the case of an asymmetric shock.

It can be argued, however, that the crisis management effort was lopsided – a stronger priority was given to fiscal stability through a rule-based framework (strengthened fiscal surveillance strictly regulating budget deficits, for instance), while integration in other fields were not as extensive. One explanation for that may be found in Germany's crisis narrative – summarized by Matthias Matthijs as "a morality tale of Southern fiscal sinners and Northern budgetary saints". In his analysis on German leadership in Europe's triple crises (the third being the Ukraine war), Matthijs calls Germany the 'enforcer in chief' in the euro crisis. He argues that Germans' negative memories of reunification transfers, the Schröder government's structural reforms being attributed to their current economic powerhouse status and a strong identity of export competitiveness fuel this crisis narrative.[71]

4.2 Implications for Schengen

It is hard to dispute that Europe's refugee problem is rooted in the instability of neighboring regions. But Europe's identity of a 'civilian power' emphasizing multilateralism, diplomacy, democracy and soft power over hard power[72] as well as its status as an 'economic giant and a military dwarf' put serious limits on directly addressing root causes: wars and poverty driving asylum seekers and giving rise to jihadist terrorism. Here as well, it is worth looking at the important role of Germany as 'Europe's reluctant hegemon', despite being the

[71] Matthijs, 2016
[72] Duchene, 1973

EU's largest country and considerable political authority, retaining from active or interventionist foreign policy strategies due to understandable historical reasons.[73]

Many observers, especially Americans criticized the EU for being "singularly ineffectual in deploying aid, diplomacy and boots on the ground to address conflicts in Africa and the Middle East" and called German renitence unacceptable. [74]

However, there is a tendency of the EU aiming for a more significant global role with a common foreign policy approach through its External Action Service (the EU's diplomatic organization), the most recent example of which is the key role European diplomacy played in the Iran nuclear negotiations resulting in the Joint Comprehensive Plan of Action.[75]

Over and above the reinforcement of Frontex and enhancing intelligence and data sharing discussed above, there are frequent rumors about plans for stronger cooperation in the field of security and defense[76] – however, not much of these have appeared in official communiqués yet. European leaders are more and more vocal about stronger integration in this field – in the aftermath of the Brussels attacks Italian Prime Minister Matteo Renzi openly called for investment in a common "security and defense structure", adding that "Europe must go all the way this time."[77] Hinting towards a historic turning point, Germany is increasing the size of its troops by 7,000 and its annual defense budget by € 5 billion by 2020.[78]

Prospects are lot gloomier when it comes to harmonizing immigration and asylum policies – another important field where the lack of a unified approach causes obvious difficulties for the Schengen area. Unfortunately, public attitudes and subsequent Member State positions are dramatically diverging on the issue of immigration and refugee policy. Leaders have trouble agreeing upon a common core of principles, let alone strategies and actions.[79] The moral imperative of Angela Merkel's *Wilkommenskultur* seemed self-evident in Germany and Sweden, while discourse even in the UK and France focused on the costs of immigration. Xenophobic sentiments in the relatively isolated societies of Central and Eastern Europe, even in East Germany were in stark contrast with more globalized Western

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73 Matthijs, 2016
74 Eichengreen, 2015
75 Martin, 2015
76 Barker et al., 2016
77 Renzi in: EurActiv, 2016
78 Blitz, 2016
79 Madár, 2015

and Northern Europe.[80] A common ground seems a long way ahead, but it is most certainly necessary for both effective short term responses and sustainable institutional solutions.

LESSON 5: In dire need of a functional crisis management mechanism, there is a reliance on non-majoritarian decision making.

Negative/ positive: (–)

Notwithstanding the myriad of EU bodies for various functional fields, Europe seems to lack legitimate mechanisms to even articulate a community interest, let alone follow through on it. High salience issues belong on highest-level intergovernmental negotiation tables with heads of governments, put under keen public scrutiny.[81] These leaders are still accountable to their domestic constituencies only, and as European crisis management capacities fail, they turn to unilateral action and beggar-thy-neighbor policies.[82] Such crisis management efforts are biased towards national interests; Member States may form interest-based alliances, but generally do not think in terms of positive sum games and lack solidarity across cleavages. This, in turn, reinforces the agendas of populist political parties already on the rise throughout Europe, making it even harder for leaders to depart from hardliner positions.

5.1 Lessons from the euro crisis

Charles Wyplosz denounced crisis management mechanisms of the Eurozone as a black hole.[83] The system of ad-hoc bailouts politicizing matters, the heads of 18 governments under constant media attention were understandably struggling to come to any meaningful compromise. Politics trumped economic analysis. A final solution was to rely on non-majoritarian institutions – prominently the European Central Bank and to a lesser extent German leadership. From the standpoint of democratic legitimacy, however, it is highly problematic that both options fail to represent the whole of the union.

Kathleen McNamara pointed out the problematic relationship between the two tracks of European integration seen is this case. Intergovernmental negotiations created the Treaties of the EU, establishing technocratic agencies and an EU-level bureaucracy for low-level

[80] Lehne, 2016
[81] McNamara, 2015c
[82] Madár, 2015
[83] Wyplosz, 2015

functionalist integration. But when a matter of enormous political sensitivity arises, it is lifted from the functionalist sphere to the highest level of summits. None of these levels have governance mechanisms that can produce both legitimate and effective outcomes in crisis situations.[84]

5.2 Implications for Schengen

Migration constitutes one of the most salient issues for the electorate, so it cannot be broken down to technocratic discussions. The security concerns brought forward by the Paris and Brussels terrorist attacks further aggravated the situation, creating more hysteria and polarization around the question.

With the lack of a European 'demos' and battered solidarity, as well as low levels of input legitimacy of decision-making processes, politically salient decisions are difficult to make. That hampers compromise over such polarizing issues. What is also lacking is a common public sphere for transnational discussions, enabling an open political debate over European concerns. These would be necessary bases for the creation of any sustainable policy framework that can handle the situation in a more functional way than the Dublin Regulation. Even though there is no equivalent of the ECB in case of foreign or security policy, there are non-majoritarian options, but due to their legitimacy problems, these should only be used as a last resort. Frank Schimmelfennig, Professor of European Politics at the ETH Zurich for instance proposed majority decision-making and infringement procedures to push agreements through the consensus-based institutions.[85] Majority decision-making on the quota-system and the implementation difficulties of the decision showed, however, the limits of such methods.

Stronger technocratic agencies like a propped up Frontex could be helpful in dealing with technical level questions escaping the inefficiency arising from politically polarized intergovernmental fora.

[84] McNamara, 2015a
[85] Schimmelfennig, 2015

Conclusion

My research explored the parallels between the crisis of the Schengen Agreement brought forth by the recent influx of refugees and the crisis of the common currency sparked by imbalances in sovereign debt and current accounts. My point of departure was that is that in both cases, the underlying cause of the crisis was the so-called 'disembeddedness' problem (coined by Kathleen McNamara for the euro crisis) – the lack of institutions supporting the cooperative scheme.[86]

I identified five key lessons from the euro crisis. (1) Assessing economic and political costs of disintegration in both cases, it can be concluded that path dependency decreases the probability of a permanent dismantling of the passport-free area. (2) Looking at the development of necessary institutions for increased risk sharing, the Eurozone provides an example for incremental progress, with reform efforts losing momentum once the pressure eases. (3) Both crises showed patterns of short-term utility maximizing strategies, actors giving up on mutually beneficial outcomes. Cooperation can be achieved by coercion, but for a positive-sum outcome, Member States need to invest in rebuilding trust and bringing polarized positions closer. (4) Fundamental problems cannot be addressed without an agreement over a crisis narrative in both cases. A common approach to foreign policy and a common ground on immigration and refugee policy must be found. (5) Mechanisms for governance and crisis management need to be bolstered with non-majoritarian institutions only used as a last resort.

Even though the euro crisis has many sobering lessons about the limits of cooperation and the failing of European institutions, Europe can use them to learn from its past mistakes. Pooling sovereignty to a significant extent and centralizing core government functions – thereby saving the euro and the Schengen area – seem to have high costs to Member States, especially in today's highly polarized political landscape with historically low levels of trust. The silver lining is that the Eurozone and the Schengen area are not only cherished symbolic achievements of the European unification project – they are more than that. Achievements that are also cemented by solid economic interests and a thick cobweb of interdependence. The borderless Europe has way more resilience than what it is given credit for.

[86] McNamara, 2015d

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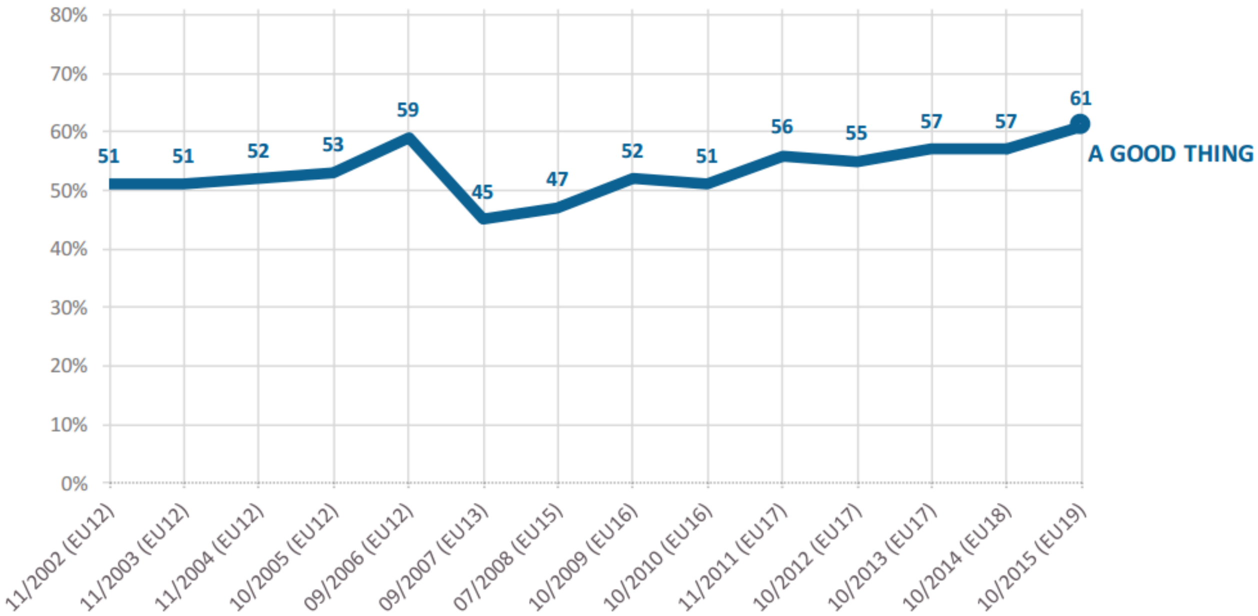
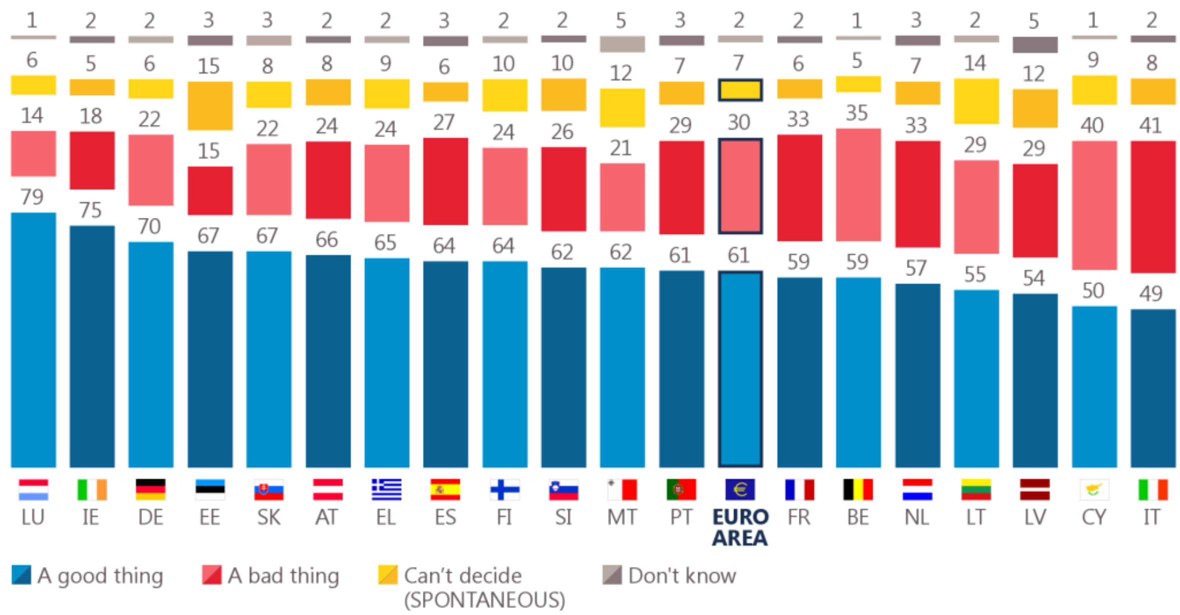
Appendix

Generally speaking, do you think that having the euro is a good or a bad thing for your country? (% euro area) [87]



Generally speaking, do you think that having the euro is a good or a bad thing for your country? (%)[88]



[87] Flash Eurobarometer 405, 2014: 8
[88] Flash Eurobarometer 405, 2014: 8